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Supreme Court, U. S.
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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1972.

No. 72-235

KEITH B. McKY,

*Petitioner,*

*vs.*

OLGA HOCHFELDER, et al.,

*Respondents.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

CHARLES AARON,
MICHAEL L. WEISSMAN,
33rd Floor-East,
One First National Plaza,
Chicago, Illinois 60670,
*Attorneys for Petitioner.*

THE GUNTHORP-WARREN PRINTING COMPANY, CHICAGO

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The petitioner, Keith B. McKy, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered on April 12, 1972.

### OPINIONS BELOW.

The opinion of the United States Court of Appeals for the Seventh Circuit, which has not yet been reported, is reproduced in full text in the Appendix hereto. (pp. A23 to A33). The opinion of the United States District Court for the Northern District of Illinois, which was not reported, is reproduced in full text in the Appendix hereto (pp. A15 to A22) as is the Report of the court-appointed Special Master (pp. A1 to A14) which was confirmed in the opinion of the District Court.

## JURISDICTION.

The judgment of the United States Court of Appeals for the Seventh Circuit was entered on April 12, 1972. A timely petition for rehearing *en banc* was denied on May 31, 1972 (p. A35) and this petition for a writ of certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked under 28 U. S. C. § 1254(1).

## QUESTIONS PRESENTED.

1. Should a United States Court of Appeals adjudicate a question clearly controlled by Illinois law by relying exclusively upon a California case which is in direct conflict with all the applicable Illinois cases?

2. Should a conflict between the United States Court of Appeals for the Seventh Circuit and the United States Court of Appeals for the Ninth Circuit concerning the construction of Section 20(a) of the Securities Exchange Act of 1934 go unresolved?

## STATUTE INVOLVED.

The statute involved herein is Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a), as amended. This statutory provision is reproduced in full text in the Appendix. (p. A36.)

## STATEMENT OF THE CASE.

The petitioner herein is the court-appointed Receiver of the property and assets of First Securities Company of Chicago ("First Securities"). Respondents Olga Hochfelder, Theresa W. Rothermel, Agnes Smith, Eugene Voita, Helen B. Feldkamp, Anna L. Jesse, William P. Jesse, Eric

W. Stubbs, Lurena T. Stubbs, Helen C. Allison, Leon N. Carnovsky, Zerah A. Drake, John M. Jackson, individually and as Trustee, and Elizabeth B. Jackson are persons who have asserted claims against the property and assets of First Securities. The Securities Exchange Commission (the "Commission") and the Customer Creditors Committee of First Securities are parties to the proceedings below but are not seeking review of the judgment and opinion below.

**Nature of the Case.**

On June 4, 1968, Leston B. Nay, President of First Securities, was found dead under circumstances indicating suicide; a suicide note was found indicating that there were improprieties in the handling of the accounts of certain of Nay's customers (Resp. Ex. 1).

At the time of Nay's death, First Securities was engaged in a stock brokerage business; it was registered with the Commission as a broker-dealer in securities and was a member of the Midwest Stock Exchange and the National Association of Securities Dealers, Inc.

Nay's suicide note indicated that he had been misappropriating funds belonging to the respondents for many years. An investigation was immediately commenced by the Commission. Based upon the findings of its investigatory staff, the Commission began this proceeding on June 10, 1968. In its complaint the Commission sought injunctive relief against First Securities and the appointment of a Receiver. The action was brought under Section 27 of the Securities Exchange Act of 1934, as amended, 15 U. S. C. § 77v(a). In its complaint, the Commission alleged that there had been violations of both Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), as amended, and Section 17(a) of the Securities

Act of 1933, 15 U. S. C. § 77a(a), as amended. A preliminary injunction was entered enjoining First Securities from the transaction of any further business; at a later date, the injunction was made permanent. On June 17, 1968, on the motion of the Commission, the petitioner was appointed Receiver of First Securities.

On July 26, 1968, an order was entered, fixing the time and prescribing the form and manner of filing proofs of claim. Subsequent to the filing of the proofs of claim, the petitioner, a certified public accountant, carefully reviewed each and every proof of claim and the accounting records and customer ledger sheets of First Securities. The respondents had filed claims based on their participation in a so-called escrow scheme which had been carried on solely by the late Leston B. Nay as his personal venture; they elected to initiate hearings on their claims when advised that the petitioner would not recommend that their claims be allowed.

In November of 1968, hearings were held on the claims of the respondents before Charles A. Bane, Esq., the Special Master appointed by District Judge Julius J. Hoffman. Although the claims of the fifteen (15) respondents were not identical in nature, they were treated as a single class of claims for purposes of the hearings and the evidence adduced was deemed applicable to all claims. (Tr. 86-7.)

On November 24, 1970, the Special Master filed his Report on the claims of the respondents with Judge Hoffman and recommended therein that all of the claims be disallowed. (pp. A1 to A14.) The petitioner moved on November 24, 1970, to confirm the Report of the Special Master and on December 22, 1970, Judge Hoffman delivered an opinion from the bench approving the Special Master's Report (pp. A15 to A22) and entered an order disallowing the claims of the respondents.

The respondents appealed to the United States Court of Appeals for the Seventh Circuit which reversed the judgment of the District Court. (pp. A23 to A33.)

**The Facts.**

The claims asserted by the respondents were based upon their participation in a spurious "escrow" scheme. Nay represented to the respondents that the "escrow" was a pool of interest-bearing deposits each of which could be redeemed either in whole or in part, within a stipulated number of days after service of appropriate notice upon Nay. The so-called "escrow" was devised and carried out by Nay without the knowledge or concurrence of any other officer, director or employee of First Securities. (Tr. 679, 713, 733, 741-3.) The escrow transactions never appeared on the accounting records and customer ledger sheets of First Securities (Tr. 733-6) and were never discovered by any of the regulatory agencies which made periodic surprise audits of First Securities. In essence, the escrow transactions were conducted solely by Nay out of a filing cabinet, small office safe and desk to which only he had access. (Tr. 708-710, 738-40, 742, 748.) Nay further secreted his escrow transactions with the respondents by insisting upon adherence to a rule that all mail addressed to him was to be opened by him and no one else. (Tr. 708, 737-8.)

The petitioner refused to recognize the claims of the respondents because the facts relating thereto plainly indicated that the escrow scheme was a private arrangement between Nay and the respondents in which Nay acted solely in his own behalf. The respondents clearly understood that the escrow transactions were divorced from the business conducted by First Securities and agreed in writing to look solely to Nay for satisfaction of their

claims. (Pet. Exs. 30, 65, 66, 76, 87, 127, 128, 129, 167, 168, 181, 196, 197, 198, 205.)

When the respondents purported to put funds into the escrow, they made their checks payable to Nay personally (or in a few instances to a bank for his personal account). (Tr. 97, 100, 101, 119-20, 216, 243, 395-7, 420-1, 474, 520-1, 529, 578, 604, 641; Drake Stip. Par. 3, Cross-exam.; Feldkamp Stip. p. 17; Carnovsky Exs. 1, 6, 9, 17, 20, 22; Allison Exs. 11 through 17; Jackson Exs. 2, 5, 8, 11, 13, 17, 19, 21, 21A, 24, 26, 28, 30; Rothermel Group Ex. 10; Pet. Exs. 78, 80, 199.) The checks were endorsed by Nay individually for deposit in his personal bank account and when cancelled, were returned to the respondents in the ordinary course of banking practice. (Tr. 396-7 and respondents' exhibits cited immediately above.)

All funds withdrawn from the escrow were remitted to the respondents by Nay's personal checks. (Tr. 107-9, 642; Drake Stip. Par. 15, Cross-exam.; Drake Ex. 21; Pet. Ex. 157.)

All moneys designated as interest on the escrow funds were paid to the respondents by Nay's personal checks drawn on his personal bank account. (Tr. 32-3, 68-9, 121, 203-4, 250, 267, 394-5, 469-70, 525, 539-41, 578, 584-5, 638-9; Drake Stip. Par. 1, 17, Cross-exam.; Feldkamp Stip. p. 17; Pet. Group Exs. 300, 301, 302, 304, 305, 306, 307, 308, 309; Pet. Exs. 303, 310.)

The respondents regularly received from Nay on an annual basis Treasury Forms 1099 showing the amount of interest paid to them by Nay during the preceding calendar year. The transmittal of these forms by Nay indicated that he was claiming a deduction for such payments on his personal federal income tax returns. (Tr. 41-2, 69-70, 127-8, 207-8, 270-1, 380-2, 458, 472-3, 506-7, 543, 639-41; Drake Stip. Par. 2, Cross-exam.; Feldkamp Stip. p. 17; Pet. Exs. 207 through 221; Pet. Exs. 104, 177.)

Nay's personal federal income tax returns for the years 1956 and 1965 were audited by the Internal Revenue Service. In connection with each of those audits, Nay wrote to the respondents advising them that his tax return was being examined and asking that they verify the amount of his indebtedness to them and the amount of the interest he had paid them during the year under review. These letters, all of which were accepted as correct by the respondents and signed by them and returned to Nay to indicate their concurrence in the statements contained therein, explicitly show that the funds delivered by the respondents to Nay for the so-called escrow gave rise to a personal indebtedness on his part and that the obligation to repay the loan and to pay the interest was his individually. (Smith Ex. 5; Pet. Ex. 181; Hochfelder Ex. 4; Pet. Ex. 87; Voita Ex. 2; Pet. Ex. 205; Pet. Ex. 30; Jackson Exs. 67, 68; Pet. Ex. 102; Stubbs Ex. 7; Pet. Exs. 196, 197, 198; Jesse Ex. 4; Pet. Exs. 127, 128, 129; Rothermel Ex. 4; Pet. Exs. 167, 168; Pet. Exs. 65, 66; Feldkamp Ex. 30; Pet. Ex. 76.)

The respondents reported the interest received from Nay as income on their own tax returns and showed Nay as the payor of the interest. (Tr. 17-18, 36, 74, 129, 206, 251, 270, 381, 427, 473-4, 543-4, 578-9, 608-9; Drake Stip. Par. 2, Cross-exam.; Feldkamp Stip. pp. 5, 17; Feldkamp Ex. 6.)

Nay's personal checking account and his income tax returns, which contained information relating to the escrow, were handled by him exclusively and kept under lock and key. (Tr. 710-1, 736-7, 740-1.)

Nay's agreements with the respondents frequently contained the express provision that "This agreement is binding and inures to the benefit of your and my heirs, executors and assigns". This, of course, is language customarily used to evidence a personal as distinguished from a corporate obligation. (Pet. Exs. 78, 79; Carnovsky Ex. 2; Stubbs Ex.

6; Anna Jesse Ex. 3; Rothermel Ex. 3; Pet. Exs. 145, 146, 161; Drake Exs. 1, 3; Feldkamp Exs. 14, 15; Pet. Ex. 74.) Each of the confirmation letters sent out by Nay to the respondents respecting the audit of his federal income tax returns contained the statement that "the indebtedness is binding upon my heirs, executor and assigns". (Pet. Exs. 30, 65; Feldkamp Ex. 30; Pet. Ex. 87; Jackson Ex. 68; Anna Jesse Ex. 4; Pet. Exs. 128, 129, 168; Smith Ex. 5; Pet. Exs. 197, 198; Voita Ex. 2.)

The fact that the respondents knew that they were dealing with Nay as an individual is manifested by their inquiries to him as to how they should proceed in the event of his death. In his responses to these inquiries Nay told the respondents that they would be taken care of by the Continental Illinois National Bank and Trust Company of Chicago, where the escrow was maintained, or by his wife or his lawyer. (Tr. 65, 133, 384-6, 538, 569, 585, 610-11.) Other respondents were advised by Nay that since the funds were in escrow the participants would be paid off "independently of the probating of my estate". (Pet. Ex. 177; Carnovsky Ex. 25.) Thus Nay's answers never involved First Securities and directed the attention of the respondents to the personal character of his obligations to them.

The respondents reposed trust and confidence in Nay individually since he was named as executor or successor executor in their wills. (Tr. 40, 156-7, 253, 272, 559, 581-2.) It was the personal relationship between the respondents and Nay individually that induced them to give him their funds for the escrow. Thus, a number of escrow advances were made by the respondents as a personal favor to Nay so that he could help friends of his. (Tr. 61, 63-4, 185, 480, 547-55; Pet. Ex. 193.) Nay's handling of the escrow in his own behalf as an individual is shown by his repeated refer-

ences to the fact that he and members of his family were participants and that he was permitting only a few close friends to come in with him. (Tr. 12-13, 96, 157, 214, 243, 379, 464-5, 537, 569, 600-2; Drake Stip. p. 2, Par. 5, Cross-exam.; Feldkamp Stip. p. 4.)

Nay at no time told the respondents that First Securities had anything to do with the escrow or that it had any interest or participation therein or that he was acting in behalf of First Securities in obtaining funds for the escrow. (Tr. 44-5, 254-5, 309-10, 425, 481, 538-9, 577, 602, 643-4; Drake Stip. Par. 5, Cross-exam.; Feldkamp Stip. p. 18.)

Those features of the escrow which should have provoked suspicion were the atmosphere of secrecy in which the matter was discussed and the unusually high rate of interest offered to the respondents on their funds. Nay told the respondents not to talk about the escrow and to keep it very quiet and that he could not divulge the name of the loan company involved. (Tr. 59, 95, 273, 308-9; 373-4, 393, 426, 428-9, 476-7, 545-6, 601-2; Feldkamp Stip. pp. 12, 16, 18; Drake Stip. Par. 5, Cross-exam.) The initial rates of interest promised to the respondents by Nay were either 12% or 9% per annum and in one instance the initial rate was as high as 4% per month. (Tr. 12, 58, 96, 157, 214, 244, 247, 310-11, 393, 448, 517, 560, 600, 644; Drake Stip. Par. 8, Cross-exam.; Feldkamp Stip. pp. 4, 12, 16.)

Although the respondents had been told that the escrow account was maintained at the Continental Illinois National Bank and Trust Company of Chicago (Tr. 65, 95, 312, 538, 585-6, 601; Drake Stip. p. 2), they made no inquiries there to verify its existence. (Tr. 115, 143, 401-2, 426, 644; Drake Stip. Par. 7, Cross-exam.) Nor did they exercise due diligence with respect to their right to withdraw their escrow deposits. Some of the respondents made no requests whatsoever for withdrawal. (Tr. 22-4, 271, 398, 425-6, 579;

Feldkamp Stip. p. 19.) Others, having received the return of some of their funds, made no request for withdrawal of the balance. (Tr. 107-8, 120-1; Drake Stip. Par. 6, Cross-exam.) Although some respondents did request withdrawals, they took no steps to enforce their requests even when Nay was obviously stalling them. (Tr. 208-9, 456, 479-80, 547, 549-50, 632-5; Carnovsky Exs. 26, 27, 29.)

During the last several years prior to Nay's death his interest payments to the respondents became irregular and delinquent, and although this was a matter of concern to them, they did nothing about it. (Tr. 81, 125-6, 215, 267, 369, 470-2, 541-3, 606-7, 565; Drake Stip. Par. 6, Cross-exam.; Feldkamp Stip. pp. 13, 14, 15.)

The security transactions engaged in by the respondents with First Securities were carried out in a far different manner than the manner in which the escrow transactions were handled. This fact further emphasizes that the escrow transactions were considered personal in nature by both Nay and the respondents.

Whenever the respondents paid for stocks they purchased through First Securities, they made their checks payable to the order of First Securities, not to Nay. (Tr. 123, 269-70, 398, 478-9, 544, 642; Feldkamp Stip. p. 20.)

Whenever the respondents had money coming for stocks they sold through First Securities, they received checks issued by First Securities, not Nay's personal checks. (Tr. 68, 119, 205, 397-8, 519-20, 529, 577-8, 642; Feldkamp Stip. p. 20.)

Whenever the respondents delivered securities or funds to First Securities in connection with their security transactions, they received regular, printed receipt forms expressly signed on behalf of First Securities. (Tr. 72, 75, 124, 204-5, 257-8, 389, 533, 641-3; Feldkamp Stip. p. 20; Feldkamp Ex. 2; Jackson Exs. 32.01, 35; Stubbs Exs. 2, 3; Anna Jesse

Ex. 1; Rothermel Ex. 1.) The respondents dealt with personnel of First Securities other than Nay in connection with their security transactions, but only with Nay with respect to the escrow. (Tr. 72-3, 75, 273-4, 301-2, 362-5, 425, 472, 546, 642-3.)

Those respondents who received statements of their accounts with First Securities noted that the statements did not include the escrow funds or the interest payments thereon. (Tr. 386-7, 645; Jackson Exs. 36.54-36.66; Allison Ex. 3.)

Although all customer transactions were regularly recorded on the books of First Securities, the escrow transactions were not. (Tr. 733-6.)

The fact that the respondents were not relying upon First Securities in their escrow dealings with Nay is further confirmed by the evidence that they never requested a financial statement from First Securities and had no information concerning its financial condition. (Tr. 39, 407, 490, 544-5, 644-5; Drake Stip. Par. 7, Cross-exam; Feldkamp Stip. p. 19.)

First Securities was an Illinois corporation with its only offices being in Chicago and Champaign, Illinois. All banking and accounting and correspondence pertaining to the escrow was handled by Nay in Chicago. The respondents generally became acquainted with Nay and made deposits into the escrow while residing in Chicago or one of the suburbs of Chicago. (Tr. 83, 151, 232-3, 286, 460-1, 498-9, 525, 591, 651, 653.)

## REASONS FOR GRANTING THE WRIT.

### 1. A United States Court of Appeals Should Not Be Permitted to Adjudicate an Issue of Substantive State Law by Disregarding All Local Decisions and by Relying Upon an Isolated Foreign Decision in Direct Conflict with Such Local Decisions Since This Is in Violation of Erie R. Co. v. Tompkins and Amounts to the Substitution of Federal Common Law for the Governing State Law.

Although the proceeding in the District Court was commenced by the Commission in reliance upon federal securities legislation, the question of whether or not the claims of the respondents should be recognized was adjudicated, in the first instance, by reference to the common law of agency rather than any federal statute.

The Court of Appeals reversed the District Court and held that Nay had acted as the common law agent of First Securities. However, the Court of Appeals adjudicated this agency question, which is clearly governed by Illinois law, by reference to a California decision which was obviously inconsistent with all the applicable Illinois cases. In this respect, the Court of Appeals utterly disregarded the rule of *Erie R. Co.* v. *Tompkins,* 304 U. S. 64 (1938) and the numerous cases which have expounded upon the *Erie* doctrine. The Court of Appeals, in substance, enunciated a federal common law of agency notwithstanding the clear mandate of *Erie* v. *Tompkins* to the contrary.

Because the respondents entered into the escrow transactions with Nay in Illinois and Nay performed all details of the so-called escrow in Illinois, Illinois law governed the determination of the agency question. Neither the Special Master nor the District Court ever considered the possibility that the law of any state other than Illinois could be

deemed controlling on the common law agency issue. But the Court of Appeals utterly disregarded the decisional law of Illinois and relied exclusively upon a California decision which cannot be reconciled with the applicable Illinois cases.

In so doing, the Court of Appeals violated the fundamental precepts of *Erie* v. *Tompkins, supra,* and other decisions of this Court which hold that a federal court, when faced with a question of purely local law, must ascertain and apply the governing local law rather than fashion its own version of what it believes the law ought to be.

In *West* v. *American Telephone and Telegraph Co.,* 311 U. S. 223, 237 (1940), this Court referred to the *Erie* doctrine and admonished a lower federal court for failure to ascertain and apply local rules of decision to a matter of substantive local law saying:

> "State law is to be applied in the federal as well as the state courts and it is the duty of the former in every case to ascertain from all the available data what the state law is and apply it rather than to prescribe a different rule, however superior it may appear from the viewpoint of 'general law' and however much the state rule may have departed from prior decisions of the federal court."

The foregoing was again reiterated by this Court in *Klaxon Company* v. *Stentor Electric Manufacturing Company, Inc.,* 313 U. S. 487 (1941), a diversity of citizenship case in which this Court held that the *Erie* doctrine required a Delaware federal court to apply state law, noting at 313 U. S. 497:

> "... the proper function of the Delaware federal court is to ascertain what the state law is, not what it ought to be."

Indeed, in the instant case the Seventh Circuit not only failed to adhere to the foregoing decisions of this Court, it

also overlooked its own opinion in *Hartzler* v. *Chesapeake and Ohio Railway Company*, 433 F. 2d 104 (7th Cir. 1970). In the *Hartzler* case the Seventh Circuit discussed its obligation under *Erie* v. *Tompkins, supra,* and *West* v. *American Telephone and Telegraph Co., supra,* saying at 433 F. 2d 107:

> "The responsibility of the federal courts, in matters of local law, is not to formulate the legal mind of the state but merely to ascertain and apply it."

The Seventh Circuit relied upon *Blackburn* v. *Witter,* 201 Cal. App. 2d 418, 19 Cal. Rptr. 842 (1962) in concluding that Nay acted as the common law agent of First Securities with respect to the escrow transactions. *Blackburn* v. *Witter,* a decision of the intermediate appellate court in California, is obviously of no assistance in ascertaining the law of Illinois. Moreover, *Blackburn* v. *Witter* was decided by reference to a provision of the California Civil Code (Calif. Civil Code § 2317) rather than as a matter of general agency law.

However, the most pernicious error which the Court of Appeals committed in relying upon *Blackburn* v. *Witter* was the fact that *Blackburn* v. *Witter* does not follow the Illinois cases which enumerate those elements which must be present to sustain a finding that an agent has been clothed with apparent authority.

In Illinois, in order for apparent authority to be created, (i) the agent must be purporting to act for his principal, and (ii) the third person must reasonably believe that the agent has authority to act on behalf of the principal. *Lawcock* v. *United States Trotting Association,* 55 Ill. App. 2d 211, 204 N. E. 2d 802 (1965); *Wing* v. *Lederer,* 77 Ill. App. 2d 413, 222 N. E. 2d 535 (1966).

The opinion in *Blackburn* v. *Witter* does not even mention the reasonableness of the third party's belief that the

agent has been authorized to act as a prerequisite to a finding that the agent had apparent authority. By mistakenly relying upon *Blackburn* v. *Witter,* the Court of Appeals failed to recognize and apply the rule of Illinois law that *a party seeking to establish that an agent has apparent authority must prove that he reasonably believed that the agent had authority to act on behalf of the purported principal.*

*Lawcock* v. *United States Trotting Association, supra,* and *Wing* v. *Lederer, supra,* expressly state that a *reasonable* belief by the third party that the agent has been granted authority to act is essential to a finding that apparent authority has been created. The long-standing Illinois rule is that the test of the reasonableness of a third person's belief that an agent has authority to act in a given transaction is whether, from the point of view of the third person, the transaction appears *regular on its face.* For example, in *Sinclair Refining Co.* v. *W. J. Newman Co.,* 224 Ill. App. 401 (1922), it was held that where a transaction is carried out in a mysterious, secret and confidential manner, a special duty of inquiry is imposed upon the person who deals with the purported agent. Thus, in Illinois, where an agent engages in a transaction which is a substantial departure from his normal course of conduct, a duty of inquiry arises. If this duty of inquiry is not satisfied, the party seeking to charge a purported principal for the acts of his purported agent cannot contend that the agent was clothed with apparent authority to act.

In the instant case the respondents could not have reasonably believed Nay had authority from First Securities because the escrow transactions were so extraordinary in nature and were such a noticeable departure from the way in which Nay customarily transacted business on behalf of First Securities.

Because the Seventh Circuit has elected to disregard the applicable Illinois cases and to rely instead upon a California case which is inconsistent with all Illinois decisions, it has evinced an utter disdain for the *Erie* doctrine and proceeded to fashion its own federal common law of agency. If *Erie* v. *Tompkins, supra, West* v. *American Telephone and Telegraph Co., supra,* and *Klaxon* v. *Stentor, supra,* are to retain their vitality and the federal courts are to be reminded of their obligation to ascertain and apply governing state law on issues of state law, this Court should grant certiorari to review the judgment of the Seventh Circuit.

**2. This Court Should Resolve the Conflict Between the Seventh Circuit and the Ninth Circuit Concerning the Proper Construction of Section 20(a) of the Securities Exchange Act of 1934 Since This Conflict Creates a Significant and Recurring Problem in Litigation Arising Under the Federal Securities Acts.**

The alternative basis upon which the Court of Appeals chose to impose liability upon First Securities for Nay's defalcations was Section 20(a) of the Securities Exchange Act of 1934. Notwithstanding the uncontroverted evidence in the record that no one at First Securities other than Nay was involved in the escrow transactions or, indeed, had even heard of the so-called "escrow", the Court of Appeals held that First Securities had not acted in good faith and could not avail itself of the exculpatory language of Section 20(a).

Thus, by its opinion the Seventh Circuit has held that vicarious liability may be imposed upon First Securities under Section 20(a) even though there was no evidence that anyone other than Nay was involved in the escrow and despite the fact that there was no possible basis for anyone at First Securities to believe that such a scheme was being conducted. Such a holding, if allowed to go unchal-

lenged, will emasculate the exculpatory proviso of Section 20(a) and will convert Section 20(a) into a statute of strict liability.

Moreover, the Seventh Circuit's opinion is in direct conflict with the Ninth Circuit's opinion in *Kamen & Co.* v. *Paul H. Aschkar & Company*, 382 F. 2d 689 (9th Cir. 1967), *cert. granted*, 390 U. S. 942 (1968), *cert. dismissed*, 393 U. S. 801 (1968). *Kamen* v. *Aschkar* arose out of the fraudulent sale of securities by agents of a stock brokerage firm and dealt with the same issue of Securities Exchange Act liability which is involved in this proceeding.

In *Kamen* v. *Aschkar*, agents of a stock brokerage firm had used the offices and facilities of the firm to carry out a fraudulent scheme wherein securities were sold with a representation that a profit was guaranteed on the resale. However, none of the remaining personnel of the firm was in any way involved in, or had any knowledge of, the fraudulent activities. The Ninth Circuit expressly held that where a controlling person neither participates in fraudulent activities nor has any reasonable grounds for believing such activities are taking place, there can be no liability under Section 20(a) of the 1934 Act. (382 F. 2d 697.) This is in direct conflict with the opinion of the Seventh Circuit in this proceeding.

The Court's attention is directed to the fact that when the Securities Act of 1933 was still in Committee, the Senate version called for an insurer's or absolute liability for controlling parties, whereas the House version afforded a controlling person the opportunity to exonerate himself from liability upon a showing that he could not reasonably have been expected to know of the wrongdoing of the controlled party. H. R. Rep. No. 152, 73d Cong. 1st Sess. 26 (1933). The ultimate acceptance of the House version left no doubt that Congress intended to alleviate controlling

parties from a strict application of respondeat superior. The decision of the Seventh Circuit thwarts the intent of Congress in promulgating Section 20(a) with exculpatory language.

Because of the rapidly expanding volume of litigation charging violations of the federal securities acts and the propensity of the parties aggrieved thereby to seek to impose liability not only upon the offending party but also those who are deemed to "control" the offender, it is of utmost importance that this Court resolve this conflict between the Circuits as to the proper interpretation of Section 20(a). The significance of this issue and the conflict between the Circuits further justify the grant of certiorari to review the judgment below.

## CONCLUSION.

For the above and foregoing reasons, a Writ of Certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

CHARLES AARON,
MICHAEL L. WEISSMAN,
33rd Floor-East,
One First National Plaza,
Chicago, Illinois 60670,
*Attorneys for Petitioner.*

August, 1972.

# APPENDIX.

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REPORT OF SPECIAL MASTER CHARLES A. BANE

IN RESPECT OF THE CLAIMS OF

OLGA HOCHFELDER, ET AL.,

FILED NOVEMBER 24, 1970.

IN THE DISTRICT COURT OF THE UNITED STATES
For the Northern District of Illinois
Eastern Division.

Securities and Exchange Commission,
*Plaintiff,*
*vs.*
First Securities Company of Chicago, a corporation,
*Defendant.*

Civil Action No. 68 C 1053.

REPORT OF THE COURT'S SPECIAL MASTER IN RESPECT OF CLAIMS OF OLGA HOCHFELDER, THERESA W. ROTHEL, AGNES SMITH, EUGENE VOITA, HELEN FELDKAMP, ANNA L. JESSE, WILLIAM P. JESSE, ERIC W. STUBBS, LURENA T. STUBBS, HELEN C. ALLISON, LEON N. CARNOVSKY, ZERAH A. RAKE, JOHN M. JACKSON, TRUSTEE, JOHN V. JACKSON, INDIVIDUALLY, AND ELIZABETH B. JACKSON ("THE ESCROW CLAIMANTS").[1]

[Filed November 24, 1970.]

Each of the fifteen escrow claimants had been a brokerage client of First Securities Company of Chicago, buying and selling stocks on which regular commissions were paid and with confirmations of the usual type for a brokerage firm being furnished. One day one of the claimants that he had obtained an opportunity for the claimant to make a favorable investment in an escrow

1. Incorporates corrections authorized by court order on Nov. 24, 1970.

which would yield a high rate of interest. He told the claimants, in his attempts to convince them to make the investment, that his wife, step-daughter and a number of close friends had invested in it. He explained the escrow as being a fund that was to be used by a small loan company (which he consistently did not name) which, according to Nay, could charge a high rate of interest under the law (up to 2½% a month) and could therefore afford to pay up to 1% a month (later reduced to 9% a year) for a portion of its funds. To fourteen of the fifteen claimants, Nay gave this advice in the offices of First Securities, although at no time did Nay tell the claimants that First Securities had anything to do with the escrow, or that it had any interest or participation therein, or that he was acting on behalf of First Securities in obtaining funds. Usually Nay told the claimants not to talk about the escrow and to keep it very quiet.

In the usual instance, the funds invested by the claimants in the escrow were derived from the sale of stocks in a transaction effected through First Securities. The proceeds were then transmitted by First Securities to the claimants, and the claimants then drew their own checks, to represent the escrow investment, payable to Nay personally (or in a few instances, to a bank for his personal account). The checks were endorsed by Nay individually.

Nay employed numerous devices to convince the escrow investors that their investment was being handled in an orderly and businesslike fashion. For example, Nay informed them that if he was out of town on an interest date, "the bank" was instructed to send out the interest checks. Further, Nay gave the impression that money had to reach him by a certain day of the month by a certified check if it was to draw interest for that month. Nay often represented that funds which could be invested in the escrow

were limited and that when there was an "opening", Nay was allowed only a portion of the investment opportunity and that this portion he was sharing with the proposed investors. Hence he would present his offer to invest in the escrow as an "opportunity".

At Nay's death, the net amounts invested in the escrow by the various claimants were as follows:

| | |
|---|---|
| Olga Hochfelder | $ 21,500 |
| Theresa H. Rothermel | 35,000 |
| Agnes Smith | 24,000 |
| Eugene Voita | 80,000 |
| Helen Feldkamp | 47,500 |
| Anna L. Jesse | 176,000 |
| William Jesse | 22,000 |
| Eric Stubbs | 129,500* |
| Lurena Stubbs | 40,000 |
| Helen Allison | 96,000 |
| Leon N. Carnovsky | 65,000 |
| Zerah A. Drake | 10,000 |
| John M. Jackson, Trustee | 70,300 |
| John M. Jackson, Individually | 89,700 |
| Elizabeth B. Jackson | 66,000 |
| | $972,500 |

Upon the making of the investment, receipt of the sum advanced was acknowledged and the terms of the arrangement were confirmed by Nay in a handwritten letter (on First Securities letterhead) signed by him as "Leston B. Nay", without any title or designation of position with First Securities (the letterhead itself did not carry his name or designation as "President"). This handwritten letter was mailed in a First Securities envelope, again with the name and address of the addressee handwritten.

In some instances, promissory notes were given to claim-

* By agreement of the counsel of the claimants and counsel of the Receiver, this amount was agreed upon in lieu of the original amount of $149,500.

ants, but in every case, they were the personal notes of Nay. In 1954 when Zerah Drake succeeded in withdrawing $30,000 of the escrow funds from Nay, Nay offered to give a note for the balance of $10,000; this offer was allowed to slip by.

Upon the making of the investment, the investor-claimant was paid interest at the promised rate by Leston Nay's personal checks, drawn on his personal bank account. Claimants regularly received from Nay, on an annual basis, Treasury forms 1099 showing the amount of interest paid to them by Nay during the preceding calendar year on the escrow funds. These forms showed that Nay was claiming a deduction for such interest payments on his personal Federal income tax returns.

During the years 1953 through 1967 (but excluding the year 1955 for which copies of the Treasury forms 1099 cannot be located in Nay's personal files), Nay paid the following total amounts of interest to the claimants on the escrow funds.

| | |
|---|---|
| Olga Hochfelder | $ 11,236.31 |
| Theresa W. Rothermel | 75,976.00 |
| Agnes Smith | 33,265.23 |
| Eugene Voita | 100,444.72 |
| Helen B. Feldkamp | 63,166.76 |
| Anna L. Jesse and William P. Jesse | 124,447.89 |
| Eric W. Stubbs and Lurena T. Stubbs | 137,397.25 |
| Helen C. Allison | 8,019.10 |
| Leon N. Carnovsky | 5,747.56 |
| Zerah A. Drake | 17,752.91 |
| John M. Jackson, Trustee | 27,601.96 |
| John M. Jackson, Individually, and Elizabeth B. Jackson | 34,495.55 |
| | $639,551.24 |

During the last several years prior to Nay's death, his interest payments to the claimants on the escrow funds became irregular and delinquent.

Nay's personal Federal income tax returns for the years 1956 and 1965 were audited by the Internal Revenue Service. In connection with each audit, Nay advised the escrow investors that his tax return was being examined and asked that they verify the amount of his indebtedness to them and the amount of the interest he had paid them during the year under review. These letters were accepted as correct by the claimants, signed by them and returned to Nay to indicate their concurrence in the statements. On their own income tax returns, claimants reported the interest received as income and showed Nay as the payor.

Nay's agreement with the escrow investors frequently contained the express provision that "This agreement is binding and inures to the benefit of your and my heirs, executors and assigns." Several of the claimants made inquiries of Nay as to how they should proceed in the event of his death. Nay told such inquiring claimants that they would be taken care of by the Continental Bank, where the escrow was maintained, or by his wife or his lawyer. Mr. Stubbs, testified that Nay told him that if Nay died the money "would be there in his estate and it would be easily reached". Nay wrote to Mrs. Drake, "If I die, file a claim against my estate with letters, receipts, etc." Other claimants were advised by Nay that since the funds were in escrow, the participants would be paid off "independently of the probating of my estate".

John M. Jackson regarded his advance as being a loan to Nay. In Jackson's Exhibit 24B, Jackson wrote to Nay, "Please reduce my loan to you from John M. Jackson, Trustee, u/w/o William H. Jackson, deceased, by $5,000, and increase my loan to you from John M. Jackson as an individual by a corresponding $5,000."

At the time of the death of Mrs. Rothermel's husband, his escrow balance of $31,000 was referred to as the "Note of Leston B. Nay" in the joint consent of the Illinois Attorney General and State Treasurer to its transfer to Mrs. Rothermel.

Mrs. Feldkamp inquired of Nay by letter, "Is the escrow fund managed through First Securities Company of Chicago, or by you as an individual?" (Feldkamp Exhibit 35). In response Nay informed Mrs. Feldkamp by telephone that the escrow participants had invested funds with him as an individual. Mrs. Feldkamp made no objections. Professor Carnovsky referred to Nay's escrow obligations as Nay's "various demand notes."*

The paper work in connection with the escrow funds bore no resemblance to the procedures followed by Nay and the claimants when a transaction was carried out through First Securities. When the claimants paid for stocks that they purchased through First Securities, they made their checks payable to the order of First Securities, not to Nay. When they had money coming from the sale of securities they received checks from the company, not Nay's personal checks. Whenever the claimants had delivered funds to First Securities in connection with their securities transactions (as distinguished from the escrow) they received regular, printed receipt forms expressly signed on behalf of First Securities. Whenever First Securities made a collection for a claimant of interest, dividends or the proceeds of a Treasury bond, the claimant would receive a regular printed form used by First Securities for that purpose.

* Since the claimants herein are individuals, and are treated as a group only because of common questions of law and fact, the Special Master does not regard the admission of any one claimant as binding the others. Hence, the admissions of Mr. Jackson, Mrs. Rothermel, Mrs. Feldkamp and Professor Carnovsky are binding only on each of them individually. But they do show a pattern in the manner in which the escrow investments were handled by Nay.

Statements of accounts received by the escrow claimants from First Securities never included any reference to the escrow transactions or the interest payments on the escrow investments.

Throughout the history of the escrow, prior to Nay's death, the escrow was unheard of by other employees of First Securities. All papers relating to the escrow were found on Nay's death under lock and key in his private office in places where other employees had no access. Nay's personal checking account and his income tax return which contained information relating to the escrow were handled by him exclusively and similarly were under lock and key. No one else in the office was permitted to open mail addressed to Nay or to his attention.

There were a few actions either on the part of claimants or of Nay himself, which related First Securities to the escrow operations, in addition to the circumstance that the original receipts and statement of terms, though handwritten, were on First Securities letterhead and mailed in a First Securities envelope. Interest checks sent by Nay, although drawn on his personal account, were sent in First Securities envelopes. Nay told Mrs. Jesse that the escrow opportunity arose because Nay, "through First Securities", had done a favor to a small investment company. Similar representations were made to Mr. Jackson, who, in forwarding his initial investment to Nay, addressed his letter to "Mr. Leston B. Nay, President, First Securities Co. of Chicago." When Mrs. Rothermel put funds into the escrow, she drew the check to the order of Leston B. Nay but sent it to First Securities in care of Nay.

Nay told Mr. Stubbs that the escrow was a "secret between his company and the finance corporation." Mrs. Allison testified that Nay was "my man at First Securities." Mr. Carnovsky was told by Nay when Carnovsky

wanted to withdraw a part of his escrow investment that Carnovsky had nothing to worry about and that "his money was safe at First Securities." Nay told the Voitas that "he and his company" had a financial arrangement with a loan company. Nay stated to Mrs. Stubbs that she had a better investment than Sears stock, through First Securities, in the escrow.

A number of the claimants were close to Nay personally. Mrs. Jackson testified that in her household the name Nay "was a household word". Six of the claimants had named Nay executor or co-executor in their wills.

In June, 1968 when Nay committed suicide, he left a note admitting that the escrows were "spurious". That was the first time that any of the claimants knew that they had been deceived.

The question under all of the foregoing circumstances is whether First Securities can be held liable for the activities of Leston B. Nay in respect of the spurious escrow. The question is basically one of agency law, and specifically whether the relationship of principal and agent can be found, with respect to the escrow transactions, between First Securities and Nay, with Nay having either actual or apparent authority from First Securities to do the things he did.

There is no question that Nay had no actual authority to act for First Securities with reference to the escrow transactions. Nothing in the record shows any action by First Securities to authorize Nay to carry out the escrow transactions and it cannot be maintained that Nay had such actual authority by reason of his position as president and principal shareholder of First Securities.

The claimants have argued, however, that there was apparent authority in Nay and cite as authority Sections 261

and 262 of the American Law Institute Restatement of the Law of Agency. Sections 261 and 262 read as follows:

Section 261:

> "A principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud."

Section 262:

> "A person who otherwise would be liable to another for the misrepresentations of one apparently acting for him is not relieved from liability by the fact that the servant or other agent acts entirely for his own purposes, unless the other has notice of this."

One of the illustrations given in the Restatement under Section 262 is this:

> "1. P, whose business is that of advising persons concerning investments, represents to T that A is his manager. At P's office, T seeks advice of A concerning investments. A, acting solely to promote an enterprise of which he is the owner, made deceitful statements in regard to it, on the strength of which T invests and loses. P is subject to liability to T."

This illustration from the Restatement is cited in *Blackburn* v. *Witter*, 1962, 19 Cal. Rptr. 843. A widow without business experience went to the brokerage office of Dean Witter and Co. and selected an employee, Mr. Long, as her investment adviser. Once a month he suggested stocks for her to buy and sell. She acted in accordance with his suggestions. He persuaded her to invest in a nonexistent company on the plea that he could get from it a higher rate of return than she was getting from her stocks. She obtained the money to invest by selling some of her stocks through Long acting as agent for his employer. He gave

her for her money "Rediform" receipts, which he later supplemented by his own promissory notes bearing 10% interest. She admitted that she received each month a transaction sheet from the broker setting forth all transactions between her and the brokerage house for the preceding month. None of the transactions between her and Long concerning the non-existent company appeared on any of these monthly reports. The brokerage firm contended that the widow must have known, or should have known, that Long, when he took her money for investment, was acting for himself and not on behalf of the brokerage house. This argument was not sustained, and a judgment against the broker was affirmed on the basis of the ostensible authority of Long to act for the broker, citing Sections 261 and 262 of the Restatement of the Law of Agency. The Court said that Dean Witter & Co. could not "concede that the part of the transaction by which respondents sold her stock through Long and the brokerage house to obtain the money was within the scope of Long's agency, while the part of the transaction whereby Long received the proceeds of the stock sale was not within the scope of his apparent authority. In short, it is difficult to see how appellants can accept the benefits of the sale of the stock by Long as their agent and deny liability for the fraudulent misuse of the money obtained by the sale of the stock." (p. 845.)

It is clear, however, that in *Blackburn* v. *Witter*, not only did the broker hold Long out as its agent but the agent represented to the customer that he was acting for his employer. It seems to be established law in Illinois (as elsewhere) that an essential element of the doctrine of apparent authority is that the agent must purport to act in the particular transaction in behalf of the principal. In the recent case of *Lawcock* v. *United States Trotting Ass'n.*, 55 Ill. App. 2d 211, 216-217 (1965), the court said:

"Apparent authority 'to do an act is created as to a third person by written or spoken words or any other conduct of the principal which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf *by the person purporting to act for him*' (Restatement of Agency 2d § 27, P. 103.)" (Emphasis supplied.)

This position has been previously recognized by the Special Master and by the Court in the former's recommendation and the latter's ruling in respect of the *Moyer* claim. The Special Master's memorandum on *Moyer* stated that the root question was "whether the transactions purported to have been carried out, on the broker's side, by Mr. Nay individually or by him on behalf of First Securities."

Judge Hoffman in his opinion approving the Special Master's recommendation stated:

". . . As the court has previously remarked with regard to the claim arising out of the securities, there are two questions involved in determining such liability,—Mrs. Moyer's understanding of the transaction being only one of them. The other question is that of tangible proof of company involvement.

"Mrs. Moyer may or may not have believed that Nay would pass her money on to whomever bought bonds and things at the company, but, in either event, she sent her check to Nay drawn to his order and did not receive a receipt identified as that of First Securities for it as she had for her securities. This was, therefore, a personal transaction. The fact that she received a cancelled check back does not tend to prove the contrary. The check was endorsed personally by Nay alone.

"For these reasons, I concur with the judgment of the Special Master and disallow this final portion of the claim". (Tr. 4-30-69, pp. 16-17.)

The Special Master finds here that Nay did not purport to act for First Securities in connection with the escrow transactions; he never told any of the claimants that he was so acting; all funds were given to him by checks made payable to him personally; all interest was paid by his personal checks; and by many different forms of written communications (such as U. S. Treasury Forms 1099, letters confirming the sums due to the claimants and the interest paid thereon for income tax audit purposes, and other documents and letters); it was clear that the escrow transactions involved Nay's personal actions rather than those of First Securities.

The circumstances under which the name of First Securities came into the escrow arrangements, such as Nay's representations that these opportunities arose because he, as president of First Securities, had done a favor for a small loan company, do not reach the level of representations by Nay that he was acting for First Securities in the escrow transactions. Nor can such representations be derived from the use by Nay of First Securities letterhead and envelopes for his handwritten notes and transmittal of personal checks for interest. In view of the widespread use of business or professional stationery by business and professional people for personal purposes, it certainly cannot be a valid rule of law that a principal or employer is bound by reason of such use alone.

The Special Master, therefore, recommends that the Court find that Leston B. Nay had no authority, actual or apparent, to act for First Securities in the escrow transactions and that accordingly First Securities is not liable for any losses resulting to the claimants from such transactions.

The parties in their briefs before the Special Master have argued the question of diligence. Counsel for the Receiver

has urged that even if Nay could be found to have purported to act as agent for First Securities, the claimants must use reasonable diligence and prudence to determine whether Nay was acting within the scope of his authority. In view of the Special Master's recommendation that the Court find that Nay ought not to be considered as having purported to act as an agent for First Securities, it is unnecessary to pass on the point of diligence.

The parties have also argued, in connection with the admissibility of conversations between the claimants and Nay, whether the Illinois Dead Man's Statute should apply to exclude such conversations. Chapter 51, Section 4, Illinois Revised Statutes, provides in pertinent part as follows:

> "... and in every action, suit or proceeding a party to the same who has contracted with an agent of the adverse party—the agent having since died—shall not be a competent witness as to any admission or conversation between himself and such agent, unless such admission or conversation with the said deceased agent was had or made in the presence of a surviving agent or agents of such adverse party, ..."

Although there had been criticism in recent years of the Dead Man's Rule and the preliminary draft of *Proposed Rules of Evidence for the United States District Courts and Magistrates* would abolish the Dead Man's rule under such circumstances as are present here, there is no doubt that in this Circuit, the federal courts have been required to follow the Illinois statute: *Hill* v. *A. J. Canfield Co.*, 157 F. 2d 849 (7th Cir. 1946). However, in the instant proceeding, there is some question whether the Dead Man's Statute should be applied since the statute requires, by its terms, that the deceased whose conversations are to be excluded be found to be an agent, whereas counsel for the Receiver and others opposing the claimants argue that there was no such agency.

The Special Master admitted the testimony subject to later rulings. The Special Master here states that such testimony did not play a substantial part in his conclusions and was not the balancing factor in determining the invalidity of the escrow claims against First Securities. The Special Master recommends that the objected to testimony be allowed to stand for informational purposes only and that the Court not base its conclusions as to whether or not to affirm the Special Master's recommendations upon such testimony in whole or in part.

In view of all the foregoing, the Special Master recommends that the Court hold that the claims of the escrow claimants, in the amounts set forth on page 3 hereof, be denied in their entirety as claims against First Securities Company of Chicago.

/s/ Charles A. Bane,
*Special Master.*

November 10, 1970.

OPINION OF UNITED STATES DISTRICT JUDGE

JULIUS J. HOFFMAN

DELIVERED DECEMBER 18, 1970.

IN THE DISTRICT COURT OF THE UNITED STATES.

• • (Caption—68-C-1053) • •

## OPINION.

Judge Hoffman: This matter, as has been indicated here, involves claims asserted against the First Securities Company of Chicago in the aggregate amount of $972,500 based upon moneys which were deposited by the fifteen claimants in a so-called escrow fund created by the late Leston B. Nay. The fifteen claimants are Olga Hochfelder, Theresa W. Rothermel, Agnes Smith, Eugene Voita, Helen B. Feldkamp, Anna L. Jesse, William P. Jesse, Eric W. Stubbs, Lurena T. Stubbs, Helen C. Allison, Leon N. Carnovsky, Zerah A. Drake, John M. Jackson, Trustee, John M. Jackson, individually, and Elizabeth B. Jackson.

During the course of the proceedings both before the Special Master and here, these fifteen claimants have been referred to as the escrow claimants. Each of these escrow claimants was a brokerage client of First Securities Company of Chicago of which the late Leston B. Nay was president and controlling stockholder.

The claims asserted against First Securities arise out of a spurious escrow fund that was created by Nay. Nay told each of the claimants of an opportunity to invest in an escrow fund which would yield a high rate of interest. To persuade the claimants to invest in the fund, Nay said that members of his family and a number of his close friends had invested in it. The claimants were told that the fund would pay a rate of interest up to one percent per month which was later reduced to 9 percent per year for a portion of its funds.

The investors in the fund were told that the fund must be

kept secret and that they should therefore not talk to others about it.

In most instances the funds invested in the escrow were obtained by the claimants through the sale of securities held by them. Those transactions were effected through First Securities. After the claimants had sold their stock, they drew their own checks for investment in the escrow and made them payable to Nay personally or to a bank for Nay's personal account.

Nay advised fourteen of the fifteen claimants to invest in the escrow fund while they were in the offices of First Securities, although Nay did not tell any of them that First Securities was managing or participating in the fund or that he was acting in behalf of First Securities in obtaining funds.

After Nay's death, the spurious nature of the escrow fund was discovered.

To recover the amounts of their investments, the investors in the escrow fund have filed their claims against the receiver of First Securities. The fifteen claims were consolidated for hearing before the court's Special Master because they presented common questions of law and fact.

The theory advanced by the claimants before the Special Master is that in obtaining funds from the claimants for investment in the escrow fund, Nay was acting with apparent authority as the agent of First Securities. It is the contention of the claimants that Nay purported to act for First Securities and is therefore liable for the claimants' loss.

After hearing testimony and reviewing numerous documentary exhibits, the Special Master found that with respect to the escrow fund scheme, Nay did not purport to act on behalf of First Securities and had no apparent authority to do so and that First Securities should not be held liable

as Nay's principal. The Master therefore recommended that the claims of the fifteen escrow claimants be denied in their entirety as claims against First Securities.

Rule 53(c)(2) of the Federal Rules of Civil Procedure provides, among other things, as follows:

> "In an action to be tried without a jury, the court shall accept the master's findings of fact unless clearly erroneous."

Unless clearly erroneous, the special master's findings are binding on the district court. In re Vernon Hills, Incorporated, 348 F. 2d 4, 7th Circuit, 1965.

Having reviewed the transcript of testimony before the Special Master and the exhibits introduced by the respective parties, and now having heard oral arguments by counsel, I have concluded that the findings of the Special Master are not only not clearly erroneous but that they are clearly correct.

Under Illinois law, he who asserts the existence of an agency has the burden of proving that fact. Nelson Development Company v. Ohio Oil Company, 45 Fed. Supp. 933, Eastern District of Illinois, 1942; Stone v. Stone, 407 Ill. 66, 1950.

There is no claim here that Nay had actual authority to act in behalf of First Securities in obtaining funds for the spurious escrow fund.

For one to be held to have had apparent authority to act as an agent, the alleged agent must have purported to act on behalf of the alleged principal. Quoting the Restatement of Agency 2d, Section 27, the court in Lawcock vs. United States Trotting Association, 55 Ill. App. 2nd 211 stated—and I am mindful of counsel's deprecating comment about the Illinois Appellate Court; nevertheless it is a highly respected court:

> "Apparent authority 'to do an act is created as to a third person by conduct of the principal which, reasonably interpreted, causes the third person to believe that the principal consents to have the act done on his behalf by the person purporting to act for him.' 55 Ill. App. 2nd at 216. See also Alterman v. Lydick, 241 F. 2d 50, 7th Circuit, 1950."

The case relied upon by the claimants, Blackburn v. Witter, 19 California Reporter 842, 1962, is not contrary to that proposition. In Blackburn the court held the broker liable for its agent's misuse of money obtained by the sale of stock. In that case, however, it was clear that the agent represented to the injured customer that he was acting for his employer. In the case at bar the Special Master found that Nay lacked apparent authority to act as the agent of First Securities because the evidence established that Nay did not purport to be acting in behalf of the company with respect to the escrow fund. That conclusion is amply supported by the circumstances surrounding the escrow fund transactions. The evidence shows that at no time did Nay specifically tell any of the claimants that he was acting on behalf of First Securities in obtaining funds for the escrow or that First Securities was involved with the management of the fund. Rather, the facts establish that the escrow fund investors dealt with Nay personally and that he acted in an individual capacity. When the claimants invested in the fund, they made their checks payable to Nay personally or in some cases to a bank for Nay's personal account and the checks were endorsed by Nay individually, not as agent or officer of First Securities. All funds that were withdrawn from the escrow fund were paid to the claimants by checks drawn by Nay on his own personal bank account. In addition, the claimants regularly received Treasury Forms 1099 showing the amount of interest paid to them by Nay for each calendar

year indicating that Nay deducted such interest payments on his individual federal income tax returns. In two years, 1956 and 1965, Nay's tax returns were audited by the government. In connection with these audits, Nay obtained from the claimants letters verifying the amount of his indebtedness to them and the amount of interest he had paid during the years under review. Those letters show that the claimants knew that the escrow gave rise to a personal indebtedness that was Nay's individually. These facts concerning the escrow arrangement are particularly significant in establishing that Nay acted individually and did not purport to act for First Securities when compared with transactions that were carried out between the claimants and the company. When the claimants purchased stocks through First Securities, they made their checks payable to the company, not to Nay, and when they received money from First Securities for stocks sold through it, the checks were drawn on the company's account, not on Nay's personal account. When the claimants delivered securities or funds to First Securities in connection with securities transactions, they received printed receipt forms signed on behalf of the company. When First Securities made collections for claimants of interest, dividends or proceeds on bonds, the claimants received a regular printed form used by the company for that purpose. And those claimants who received statements of their accounts with First Securities observed that the statements did not include the escrow fund or the interest payments thereon.

All of these factors concerning the manner in which the escrow fund transactions were carried out in contrast with other business between the claimants and First Securities establish that Nay did not purport to act on behalf of the company and could not reasonably have been thought to do so.

The only significant fact which the claimants cite that lends any credence to their view that Nay purported to act in behalf of First Securities is that some of the correspondence from Nay to the claimants was written on First Securities' letterhead and was mailed in First Securities envelopes. While this fact may not be without relevance, it is not entitled to great weight since it is not uncommon for business or professional people to write personal letters on office stationery. I do it every day.

During the course of the hearings before the Special Master, some testimony concerning statements made by Nay was objected to on the ground that it is inadmissible under the Illinois dead man's statute, Illinois Revised Statutes, Chapter 51, Section 4. The Master received the testimony subject to later ruling on the objections, observing that there is some doubt as to the applicability of the statute to this case.

I have concluded that it is unnecessary to determine the applicability of the statute to the evidence received by the Master because that evidence has not been significant in my determination of the issues presented. Neither my nor the Master's conclusions were based upon testimony objected to. On the other hand, none of the evidence in dispute, if admissible, would be sufficient to alter my disposition of this case.

The parties also argued before the Special Master the question of the claimants' diligence to determine whether Nay had actual authority to act on behalf of First Securities in the escrow transaction. I concur with the Master that it is unnecessary to rule on this issue in view of my ruling that Nay had no apparent authority to act for First Securities.

The claimants have also argued that First Securities should be held liable for the violation of Securities and

Exchange Commission Rule 10b-5 promulgated pursuant to Section 10(b) of the Securities and Exchange Act of 1934, 15 U. S. C. § 78(j).

The finding that Nay acted individually and not as agent for First Securities, however, precludes imposition against the company as the wrongdoer's principal. See Ross v. Licht, 263 Fed. Supp. 395, Southern District of New York, 1967; Carr v. Warner, 137 Fed. Supp. 611, District of Massachusetts, 1955; Nash v. J. Arthur Warner & Company, 137 Fed. Supp. 615, District of Massachusetts, 1955.

The claimants have cited a number of cases which are inapposite to the situation here. There is no evidence to support a finding that First Securities knew or had reasonable cause to know that Nay was carrying out his transactions with respect to the escrow fund fraud. Nor is there any evidence to establish that First Securities was guilty of inadequate supervision of its agent. Nay's guilt in keeping a private record of the escrow transactions and not entering them on the company's books cannot be imputed to First Securities. Nor is the fact that the other employees of First Securities did not open mail addressed to Nay even remotely analogous to the situation in which securities dealers have been held liable under Rule 10b-5 for inadequate supervision.

Furthermore, I cannot agree with the claimants' view that First Securities may be held liable for Nay's fraud under Section 20(a) of the Securities and Exchange Act, 15 U. S. C. § 78. That section provides:

> "Every person who directly or indirectly controls any person liable under any provision of this chapter or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling per-

son acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or causes of action."

Thus First Securities Company would be liable for the acts of its "controlled person" under Section 20(a) only if it acted in bad faith or induced the unlawful acts. There is not sufficient evidence that First Securities acted in bad faith with respect to the escrow funds, or that it directly or indirectly induced the fraud.

In view of the foregoing, I must conclude that First Securities is not liable for the acts of Leston B. Nay and that the claims of the escrow claimants should be denied.

OPINION OF THE UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

DELIVERED APRIL 12, 1972.

IN THE UNITED STATES COURT OF APPEALS.

* * (Caption—No. 71-1272) * *

---

Argued January 24, 1972—Decided April 12, 1972.

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Before SWYGERT, *Chief Judge*, HASTINGS, *Senior Circuit Judge*, and SPRECHER, *Circuit Judge*.

SWYGERT, *Chief Judge*. This is an appeal from the disallowance of fifteen claims of individuals in the total amount of $972,500 asserted against the assets of a securities brokerage firm with regard to which an equitable receivership is in progress in the district court. The defendant in the equitable receivership, First Securities Company of Chicago (hereinafter, "First Securities"), was registered with the Securities and Exchange Commission as a broker-dealer in securities and was a member of the Midwest Stock Exchange and the National Association of Securities Dealers, Inc. On June 4, 1968, Leston B. Nay, President of First Securities and owner of 92 percent of its stock, murdered his wife and committed suicide, leaving a suicide note which described First Securities as being bankrupt because of his thefts and which described certain "escrows" which were his creation as "spurious." On June 10, 1968, the SEC initiated this receivership action against First Securities. The claims which are the subject matter of this appeal derive from Nay's creation of and dealings in a fraudulent escrow account. The district court appointed a special master to hear and determine the validity of these claims. In accordance with the recommendation and findings of the special master, the district court disallowed all of the instant claims in their entireties, and this appeal followed.

The special master specifically found most of the following facts to be established by the evidence, which findings

the district court approved. The remaining facts stated here are undisputed in the record. The fifteen claimants had each been brokerage clients of First Securities, buying and selling securities through First Securities in regular fashion. Each received investment advice from Nay, and each knew Nay to be the president of First Securities. Nay advised each of the claimants that he was able to offer to the claimant an opportunity to invest in a so-called escrow which would yield a high rate of interest (generally twelve percent per annum, but later reduced to nine percent). As to fourteen of the claimants he recommended investment in the escrow when the claimants were actually in the offices of First Securities. He explained that the escrow opportunity had come to him because he had done a favor for a small investment company through First Securities. Although Nay was always somewhat vague and secretive about the details of the escrow (he explained that the escrow was necessarily a "secret" between First Securities and an unnamed finance company), he described the escrow as being a fund which was to be used as the principal from which a small loan company would make loans. He further explained that the loan company could charge up to 2½ percent per month interest under the law, thus enabling the investors in the escrow to realize the high rates of interest promised. Typically, upon being persuaded by Nay that the escrow was the best possible investment for them, the claimants sold legitimate securities through First Securities for purposes of obtaining the necessary cash to invest in the escrow. First Securities effected the sales, collected its commissions and submitted the proceeds to the claimants, who then drew their personal checks payable to Nay or to a bank for his account. Subsequent transactions with regard to the escrow were not in the form usual to dealings between customers and First Securities, nor was the escrow reflected in periodic accountings by First Securities to the claimants.

Upon receipt of the cash investment from the claimants Nay usually executed a handwritten document which acknowledged such receipt and confirmed the terms of the arrangement. Sometimes Nay gave promissory notes to the claimants. All, or substantially all, of Nay's correspondence with the claimants was written on letterhead stationery of First Securities. Some of the letterhead stationery included the words, "Leston B. Nay, President," on the upper left hand portion thereof. All of the stationery bore the legend, "Member Midwest Stock Exchange," in addition to the firm's name and address. Although much of Nay's correspondence with regard to the escrow transactions was handwritten by him, a substantial portion was typed by his secretary at First Securities.

During the early years of Nay's fraudulent enterprise, the claimants were paid interest from time to time based upon their "investments" in the escrow. Such payments were made by Nay's personal check sent in an envelope upon which First Securities' name and address appeared in the upper left hand corner in the position normally occupied by the return address of the sender. The interest payments were erratic and delinquent during the later years of the operation of the scheme. During the period of 1953 through 1967, with the exception of 1955, Nay's files revealed that he sent Treasury forms 1099 to each of the claimants which showed that the distributions of interest to them had been reported as a deduction from his personal income tax return. The claimants reported the interest payments on their income tax returns in accordance with the forms 1099 received from Nay. In connection with Internal Revenue Service audits of Nay's personal federal income tax returns for 1956 and 1965, he sent form letters to each of the claimants asking that they verify the amount of his indebtedness to them and the amount of interest he had paid them during the

year in question. Each of the claimants returned the letters marked and signed to indicate their concurrence with the amounts shown thereon as received from Nay. Also, from time to time some of the claimants referred to their escrow investments in correspondence with Nay as being personal loans to him.

As to some of the claimants, Nay's receipt for investments in the escrow took the form of a purported agreement or promissory note from Nay to the claimant which recited, "This agreement is binding and inures to the benefit of your and my heirs, executors and assigns." Upon direct inquiries from several claimants, Nay vaguely indicated that the escrow would be settled in the event of his death either by the bank which was supposed to be the locus of the escrow account, or by his wife or his lawyer. He told one claimant that in such event a claim should be filed against his estate. On the other hand, he advised some that since the funds were in escrow they would be handled outside the probating of his estate. He also told one claimant who was seeking to withdraw some of his investment from the escrow that his money "was safe at First Securities." By the same token, Nay from time to time had successfully dissuaded claimants from withdrawing money from the escrow to invest in other things.

Finally, it is clear that Nay had no actual authority to act for First Securities with regard to the escrow account. It is also clear that First Securities' employees (other than Nay) knew nothing of the nature of the escrow nor, except for his secretary, even of its existence. Nay had forbidden anyone other than himself to open mail addressed to him, and in his absence all such mail was simply allowed to pile up on his desk, even if it was addressed to First Securities for his attention.

The claimants assert that the foregoing facts entitled them to recover from First Securities their losses due to

Nay's fraud. They urge the propriety of that result on two grounds: that Nay acted with apparent authority as the common law agent of First Securities and that Nay and First Securities violated or are liable for violations of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 of the Securities and Exchange Commission and Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. The special master and the district court rejected claimants' view on both theories and dismissed the claims. We reverse.

## I.

Claimants' assertion that First Securities is liable as his principal for Nay's fraud is based in part on sections 261 and 262 of the Restatement of Agency, Second (1958). Section 261 states:

> A principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud.

Section 262 provides:

> A person who otherwise would be liable to another for the misrepresentation of one apparently acting for him is not relieved from liability by the fact that the servant or other agent acts entirely for his own purposes, unless the other has notice of this.

Example one of the illustrations given under section 262 is as follows:

> P, whose business is that of advising persons concerning investments, represents to T that A is his manager. At P's office T seeks advice of A concerning investments. A, acting solely to promote an enterprise

of which he is the owner, made deceitful statements in regard to it, on the strength of which T invests and loses. P is subject to liability to T.

Claimants also cite *Blackburn* v. *Witter,* 201 Cal. App. 2d 518, 19 Cal. Rptr. 842 (1962). The *Blackburn* case was also concerned with the liability of a broker-principal for the defrauding of a customer by its salesman-employee. The customer in *Blackburn* was a widow without business experience who had regularly been given investment advice by one Long, an employee of Dean Witter & Co. Long persuaded the customer to sell some of her regular securities through him as agent for Dean Witter & Co. and to invest the proceeds of the sale in a nonexistent company which he said would produce a higher return than usual. Long gave the customer receipts which were different from those used by his employer, later supplemented by his personal promissory notes bearing ten percent interest. The customer admitted that the transactions with Long were never reflected in periodic summaries of her transactions with Dean Witter & Co. submitted to her by that firm. The court there rejected the employer's argument that the widow knew or should have known that the transactions involving Long and the nonexistent company were personal to Long and not a part of his agency for his employer and held Dean Witter & Co. liable, citing Sections 261 and 262 of the Restatement. The crux of the court's decision was its conclusion that Dean Witter & Co. could not treat the portion of the transaction by which Long sold the widow's stock at her request as being within the scope of his agency and, at the same time, expect to prevail on its argument that the purchase of the fraudulent stock by Long with the proceeds of the sale was Long's personal act outside the agency relationship. 201 Cal. App. 2d at ....., 19 Cal. Rptr. at 845.

The special master concluded that in the instant case Nay did not act with apparent authority from First Securities *vis-a-vis* the claimants. Since the facts upon which he based that conclusion were essentially those we have recited above, we have determined that his conclusion is clearly erroneous. The genesis of the special master's error is unclear, but apparently he believed that verbal representations by Nay that he was acting on behalf of of his principal, First Securities, were essential to liability. We believe that sections 261 and 262 of the Restatement, example 1 to section 262, and *Blackburn* v. *Witter, supra,* belie such a position. We hold that those authorities are clearly dispositive of the agency theory herein and that they compel the conclusion that claimants are entitled to recover from First Securities. There is no direct authority on point in the Illinois case law, but we are convinced that Illinois courts would not differ on this issue from the rule stated in the Restatement and the *Blackburn* case.

II.

Claimants also contend that they are entitled to assert their claims under the Securities Exchange Act of 1934 against First Securities on the ground that it is liable for Nay's fraud for one or more of the following reasons: (1) First Securities was a "controlling person" as to Nay within the intendment of section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a); (2) First Securities, at best, aided and abetted Nay in violating section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and Rule 10b-5 promulgated pursuant thereto, 17 C. F. R. § 240.10b-5; or (3) First Securities failed to satisfy its duty to supervise Nay pursuant to Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc.

It is clear that Nay's conduct violated the provisions of section 10(b) of the Securities Exchange Act of 1934 and its regulatory corollary, Rule 10b-5. Both proscribe the use of any means of interstate commerce or of facilities of national securities exchanges to defraud or deceive in connection with the purchase or sale of any security. The parties do not contest the fact of Nay's violation of section 10(b) and Rule 10b-5, for he clearly violated both of them. Defendant asserts, however, that Nay's fraud is not properly chargeable to First Securities. We disagree. We believe that First Securities is liable for Nay's fraud under the Securities Exchange Act on each of the three theories advanced by the claimants.

Section 20(a) of the Securities Exchange Act of 1934 provides as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. 15 U. S. C. § 78t(a).

Although the statute does not define what constitutes "control" for purposes of the foregoing, we have no doubt that Nay, being the employee of First Securities as its president, was "controlled" by First Securities within the intendment of section 20(a). *See Hawkins* v. *Merrill, Lynch, Pierce, Fenner & Beane,* 85 F. Supp. 104, 122-23 (W. D. Ark. 1949).

The special master ignored this argument of claimants based on section 20(a), but the district judge rejected it, saying merely:

> "... First Securities Company would be liable for the act of its 'controlled person' under Section 20(a) only if it acted in bad faith or induced the unlawful acts. There is not sufficient evidence that First Securities acted in bad faith with respect to the escrow funds, or that it directly or indirectly induced the fraud."

However, the district judge gravely misapprehended the operation of section 20(a). As the Eighth Circuit observed in *Myzel* v. *Fields*, 386 F. 2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U. S. 95 (1968): "The statute is remedial and is to be construed liberally. It has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." Indeed, it has been held that "to satisfy the requirement of good faith [in order for a controlling person to avoid liability thereby] it is necessary for the [controlling person] to show that some precautionary measures were taken to prevent the injury suffered," *Lorenz* v. *Watson*, 258 F. Supp. 724, 732 (E. D. Pa. 1966), and "that failure of the controlling person to maintain and diligently enforce a proper system of internal supervision and control constitutes participation in the misconduct and the violation will be deemed to have been committed, not only by the controlled person, but also by the controlling person who did not perform the duty to prevent it." *Hecht* v. *Harris, Upham & Co.*, 283 F. Supp. 417, 438 (N. D. Cal. 1968), *modified on other grounds*, 430 F. 2d 1202 (9th Cir. 1970). Given the fact that First Securities enforced the rule established by Nay that mail addressed to First Securities at its office marked for his attention was to be opened by no one but Nay, we believe the firm directly facilitated the prolonging of the fraud, if not its very inception. We hold that First Securities was a controlling person of Nay and failed to act in good faith as those terms are used in section 20(a).

Claimants also assert that First Securities is liable for Nay's fraud as his aider and abetter without regard to whether it was a controlling person as to him. It is clear that one who aids and abets a violation of section 10 of the Securities Exchange Act of 1934 and Rule 10b-5 may be held civilly liable to one who is injured thereby. *Brennan* v. *Midwestern United Life Ins. Co.*, 417 F. 2d 147 (7th Cir. 1969); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F. 2d 135 (7th Cir. 1969); *Anderson* v. *Francis I. DuPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968); *Hawkins* v. *Merrill, Lynch, Pierce, Fenner & Beane, supra.* Moreover, liability predicated on aiding and abetting may be founded on less than actual knowledge and participation in the activity proscribed by section 10 and Rule 10b-5. *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra* at 144.

In the *Buttrey* case we held that a broker-dealer would be liable as an aider and abetter to violations of section 10 and Rule 10b-5 committed by a *customer* of the brokerage firm. The act of the brokerage firm which provided a foundation for such vicarious liability was allowing the customer to trade in securities through a cash account in spite of his known financial instability and "erratic trading practices." In the *Brennan* case we held that an issuer of stock was liable as an aider and abetter to similar violations committed by a dealer in the stock on the ground that the president and general counsel of the issuer knew or should have known that the dealer was defrauding purchasers of the issuer's stock. We believe that the instant case presents a far more compelling case for the imposition of liability as an aider and abetter than either *Buttrey* or *Brennan.* Here, First Securities made Nay its president, provided him with the trappings of a successful investment counsellor, held him out as providing such counsel, and then wilfully allowed Nay's enforcement of a rule regarding the opening of mail which was antithetical to the prevention of

frauds of the type which occurred. We hold that First Securities aided and abetted Nay's fraud and is jointly liable therefor.

Finally, claimants urge us that First Securities failed to comply with Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc., of which it was a member. The rules of the N. A. S. D. were promulgated pursuant to section 15A of the Securities Exchange Act of 1934, 15 U. S. C. § 78o-3. Rule 27 provides in pertinent part as follows:

> (a) Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.
>
> (b) Final responsibility for proper supervision shall rest with the member. . . .
>
> (c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

We have no doubt that the enforcement of Nay's rule regarding the opening of mail is sufficient without more to constitute a violation of Rule 27. Such violations provide a basis for private damage actions where the rule violated serves to protect the public. *Avern Trust* v. *Clarke*, 415 F. 2d 1238, 1242 (7th Cir. 1969); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra* at 142-43. First Securities is properly liable for Nay's fraud because of its violation of Rule 27 of the N. A. S. D.

The judgment of the district court is reversed.

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DENYING PETITION FOR REHEARING ENTERED MAY 31, 1972.

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Chicago, Illinois 60604

May 31, 1972

Before

Hon. LUTHER M. SWYGERT, *Chief Judge*

Hon. JOHN S. HASTINGS, *Senior Circuit Judge*

Hon. ROBERT A. SPRECHER, *Circuit Judge*

SECURITIES & EXCHANGE COMMISSION,
*Plaintiff,*
*vs.*
FIRST SECURITIES CO. OF CHICAGO,
*Defendant.*

OLGA HOCHFELDER, ET AL.,
*Claimants-Appellants.*

KEITH B. McKY,
*Receiver-Appellee.*

No. 71-1272

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

On consideration of the petition for rehearing and suggestion that it be heard en banc filed in the above entitled cause by Keith B. McKy, Receiver-Appellee, no judge in regular active service having requested a vote thereon, nor any judge voted to grant the suggestion, and the panel having voted to deny a rehearing,

IT IS ORDERED that the petition for a rehearing in the above entitled cause be and the same is hereby denied.

Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a), as amended, reads as follows:

§ 78t. Liabilities of controlling persons

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

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FILED
AUG 23 1972
MICHAEL RODAK, JR., CLE

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1972.

## No. 72-235

KEITH B. McKY,

*Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL.,

*Respondents.*

## BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

WILLARD L. KING,
LEON M. DESPRES,
ALEX ELSON,
135 South La Salle Street,
Chicago, Illinois 60603,
*Attorneys for Respondents.*

THE BLAKELY PRINTING COMPANY, CHICAGO

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1972.

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**No. 72-235.**

---

KEITH B. McKY,

*Petitioner,*

*vs.*

OLGA HOCHFELDER, ET AL.,

*Respondents.*

---

## BRIEF OF ESCROW CLAIMANTS IN OPPOSITION TO PETITION FOR CERTIORARI.

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### THE PETITION MISSTATES THE FACTS.

The case presented by petitioner's Statement of Facts is not the case scrupulously stated in the opinion of the Court of Appeals. The petition omits the most significant facts and misstates other facts.

The petitioner's Statement of Facts omits the fact that Nay was President of First Securities Company and the owner of 92% of its stock; that the escrow claimants had been long-time customers of First Securities Company; that Nay as President of First Securities constantly gave them investment advice; that Nay told the escrow claimants that the escrow opportunity had arisen because he had done a favor for a small investment company through First Securities. To fourteen of the fifteen claimants Nay first recom-

mended the investment in the escrow when the claimants were actually in the office of First Securities Company. Typically the escrow claimants sold their legitimate securities through First Securities to get the money to invest in the escrow. The claimants' receipts for their escrow investment and all correspondence with them regarding it was on the letterhead of First Securities. (Pet. A23-27.) Although Nay paid the interest on the escrow with his personal checks, they were transmitted in envelopes of First Securities Company. (TR. 17; 46; 80; 106; 136; 201; 458; 503; 539-40; 562; 607-8; 663-4.)

Only by omitting these facts can the petition state that the respondents clearly "understood that the escrow transactions were divorced from the business conducted by First Securities and agreed in writing to look solely to Nay for satisfaction of their claims." (Pet. p. 5) There is no basis in the record for this statement. Furthermore, the petitioner errs when he states, "The so-called 'escrow' was carried out by Nay without the knowledge . . . of any other . . . employee of First Securities Company". The record is replete with letters about the escrow dictated by Nay in the office of the Company to secretaries employed by the Company". (Tr. 218; 441; 463; 495; 684; 686-690; 714-5; 718-9; Ex. 156, 195, 200; Jackson Ex. 47; Voita Ex. 6; Smith Ex. 6-7; Feldkamp Exs. 4, 11, 12, 13, 18, 21, 26, 27, 31, 33.)

Petitioner is quite wrong when he says (Pet. p. 9): "Nay at no time told the respondents that First Securities had anything to do with the escrow or that it had any interest or participation therein or that he was acting in behalf of First Securities in obtaining funds for the escrow."

Actually:

1. He told claimant Hochfelder that "As President of

First Securities'' he had been given an opportunity to handle the escrow. (Tr. 57-9)

2. In attempting to convince claimant Lurena Stubbs not to purchase stock of Sears-Roebuck & Company, but instead to make a further investment in the escrow, Nay said to her that she had a better investment than Sears "through First Securities'' in the escrow. (Tr. 500-1)

3. He asked claimant Eric Stubbs not to divulge information about the escrow investment since it was a secret "between his Company'', i.e. First Securities, ''and the financial corporation''. (Tr. 488)

4. In 1968, just before Nay's suicide, after claimant Carnovsky had requested withdrawal of part of his escrow investment, Nay said to him, ''You have nothing to worry about. Your money is safe at First Securities.'' (Tr. 198)

## I.

### ON TWO INDEPENDENT BASES FOR THE DECISION THE PETITION MAKES NO CLAIM OF ERROR.

The opinion of the Court of Appeals is based on *four* independent alternative grounds:

1. First Securities Company is liable under the common law of Illinois. (Pet. A. 27-29.)

2. First Securities Company did not act in good faith as a ''controlling person'' of Nay. (Pet. A. 30-31.)

3. First Securities Company is liable as an aider and abettor of Nay's fraud under § 10b of the Securities Act of 1934 and Rule 10b 5 of the SEC. (Pet. A. 32-33.)

4. First Securities Company is liable for its failure to comply with Rule 27 (c) of the Rules of Fair Practice of the National Association of Securities Dealers. (Pet. A. 33.)

The decision of the Court of Appeals is *independently* based on each one of these grounds.

The petition for certiorari nowhere suggests that there was any error in the third and fourth bases for the decision. It limits its claim of error to the first two of these bases.

## II.

### THE DECISION DOES NOT VIOLATE THE ERIE DOCTRINE

This is perhaps the first time that a decision of a Court of Appeals, on state law, based upon the Restatement of the American Law Institute, has been claimed to violate the Erie doctrine. The Court of Appeals stated: "There is no direct authority in point in the Illinois case law, but we are convinced that the Illinois courts would not differ on this issue from the rule stated in the Restatement and the *Blackburn* case." (Pet. A. 29.) The *Blackburn* case was not cited as an "isolated" case as the petition claims, (Pet. 12) but because it was expressly based upon the Restatement and it applied the Restatement to facts strikingly similar to those of the case at bar. (Pet. A. 27-29.) The Illinois courts have adopted the Restatement of Agency in many cases (*Henn* v. *Industrial Commission*, 1954, 3 Ill. 2d 325, 327; *M. & J. Diesel Corp.* v. *Nettleton*, 1965, 56 Ill. App. 2d 146, 151).

After the decision in the case at bar, another panel of the Court of Appeals for the 7th Circuit reversed another decree of the District Court denying a large investor's claim in the First Securities case. This reversal was on the same four bases as the reversal which Petitioner now seeks to attack. (See opinion attached, Appendix A.)

The Illinois cases cited by the petitioner are irrelevant on their facts.

## III.

### THERE IS NO CONFLICT BETWEEN CIRCUITS.

Petitioner argues that certiorari must be granted because there is a conflicting decision in the 9th Circuit (*Kamen & Co.* v. *Paul H. Aschkar & Company*, 382 F. 2 689, 9th Circuit, 1967). However, this is not a citable case.

Aschkar was a California broker buying and selling unlisted securities. Kamen was a member of the New York Stock Exchange dealing in listed securities. A rule of the NYSE forbade direct or indirect rebates of commissions. To thwart this rule and to increase Kamen's commissions on listed sales, two Kamen employees concocted a scheme.

These employees telephoned brokers dealing in unlisted securities and suggested their purchase of stock which these employees owned in a worthless corporate shell. They instructed Broker A what price he should pay for the shares and guaranteed that the shares could be re-sold to Broker B at a slightly higher price. They told Broker B to buy from Broker A and resell to Broker C for a fixed fractional markup. This created a continuing chain in which each buying and selling broker was guaranteed a profit in return for giving listed securities business to Kamen. For a time this scheme succeeded. Kamen received large commissions on his increased listed-stock business generated by this project. But the SEC discovered the scheme, investigated and denounced it. Aschkar was left holding worthless stock for which it had paid some $25,000 and which its guaranteed buyer refused to take. Sixteen other dealers in unlisted securities were in the same predicament. (Aschkar Pet. Cert. October Term, 1967, No. 665, later No. 4, Appendix G.)

Aschkar sued Kamen for the fraud of Kamen's employees. The District Court held that Kamen did not know of the fraud of his employees and therefore was not liable

to Aschkar under the Securities Acts but was liable for common law fraud. This judgment was reversed by the 9th Circuit Court of Appeals on the ground that Aschkar had been previously employed by a NYSE broker and knew that the rule of that Exchange forbade direct or indirect rebates. Aschkar therefore could not have assumed that Kamen's employees were acting within the scope of their authority. All this was on the basis of the common law.

However, Aschkar had taken a protective cross-appeal relying *inter alia* on § 15 of the 1933 Securities Act and § 20a of the 1934 Securities Act imposing liability for fraud of controlling persons. The Court of Appeals held that since the test of such liability was that the controlling person had acted in bad faith and had directly or indirectly induced the fraud, Kamen was not liable under these sections because he had no knowledge of the fraud.

Aschkar filed a petition for certiorari in this Court. This Court then invited the Solicitor General to file a brief expressing the views of the United States.( December 4, 1967, 389 U. S. 966.) Solicitor General Griswold filed a memorandum with this Court recommending that certiorari be allowed, because the legislative history clearly showed that the exculpatory clauses for "controlling persons" who acted in good faith had no application to a broker's liability for violation by its employees of the Securities Acts. That liability was absolute. He said that the decision thus unduly impeded private rights of action for violation of the Securities Acts which were necessary to the enforcement of those Acts.

Certiorari was then allowed and the case was placed on the summary calendar (March 4, 1968, 390 U. S. 942.) The Solicitor General and the attorneys for the SEC then filed such a devastating brief (copy attached hereto as Appendix B) that Kamen could not refute it and made restitution not only to Aschkar, but to the 16 other unlisted stock brokers

who had filed similar suits in New York. It will be noted that the Solicitor General and the SEC (App. B pp. 13-17) do not agree with the summary purported legislative history which the Petitioner here presents. (Pet. p. 17.)

The petition for certiorari was then (September 3, 1968, 393 U. S. 901) dismissed under Rule 60, and the opinion of the Court of Appeals no longer had any authority as a precedent. For a short time it was cited in a few cases, but only to distinguish it. (See distinction of it by Kaufman, J., in *Johns Hopkins* v. *Hutton*, 1968, 297 F. Supp. 1165, 1210-12, 1236, affirmed C. A. 4, 422 F. 2d 1124, 1130: "For reasons fully stated by Judge Kaufman we agree that Section 15 of the Act (15 U. S. C. § 77o) was not intended to insulate a brokerage house from the misdeeds of its employees.") No court has ever followed *Kamen* v. *Aschkar* in its interpretations of § 15 of the 1933 Securities Act and § 20a of the 1934 Securities Act. The District Court expressed the same erroneous interpretation in the case at bar (Pet. A. 21-22), but the District Court did not cite *Kamen*. No citation of it is recorded in the latest citator.

It is submitted that certiorari should be denied.

Respectfully submitted,

WILLARD L. KING,
ALEX ELSON,
LEON M. DESPRES,
135 South La Salle Street,
Chicago, Illinois 60603,
*Attorneys for Respondents.*

# In the
# United States Court of Appeals
## For the Seventh Circuit

SEPTEMBER TERM, 1971 — APRIL SESSION, 1972

No. 71-1422

SECURITIES AND EXCHANGE COMMISSION,
*Plaintiff,*

v.

FIRST SECURITIES COMPANY OF CHICAGO,
*Defendant.*

UNION BANK & TRUST COMPANY, HELENA, MONTANA,
*Claimant-Appellant,*

KEITH S. MCKY,
*Receiver-Appellee,*

CUSTOMER CREDITORS COMMITTEE,
*Committee-Appellee.*

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 68 C 1053

JULIUS J. HOFFMAN,
*Judge.*

ARGUED APRIL 13, 1972 — DECIDED AUGUST 1, 1972

Before HAMLEY,* STEVENS and SPRECHER, *Circuit Judges.*

SPRECHER, *Circuit Judge.* This is another sad chapter in the case of Leston B. Nay and the frauds he perpetrated over a long period of years against a great number of innocent investors. The record in this court in the prior appeal of 15 individual escrow participants, Olga Hoch-

* Circuit Judge Frederick G. Hamley of the United States Court of Appeals for the Ninth Circuit is sitting by designation.

felder et al., has been made part of the record in this appeal. *SEC* v. *First Securities Co.*, ..... F.2d ..... (No. 71-1272, April 12, 1972).

The defendant in the equitable receivership, First Securities Company of Chicago, was registered with the Securities and Exchange Commission as a broker-dealer in securities and was a member of the Midwest Stock Exchange and the National Association of Securities Dealers. On June 4, 1968, Leston B. Nay, president of First Securities and owner of 92 percent of its stock, murdered his wife and committed suicide. He left a suicide note which described First Securities as bankrupt because of his thefts and which characterized the "Schueren account" as being one of "the thefts affecting the Company."

On June 10, 1968, the SEC initiated the receivership action against First Securities. The claim which is the subject matter of this appeal derives from Nay's theft of securties owned by Arnold C. Schueren. The district court appointed a special master to hear and determine the validity of the various claims against First Securities. In accordance with the recommendation and findings of the special master, the district court disallowed the instant claim on behalf of the estate of Arnold C. Schueren in its entirety, and this appeal followed.

I

On April 16, 1936, Arnold C. Schueren appointed Nay "to act for me in connection with all matters arising out of or in any way connected with my securities to the same extent and with the same full power and authority as I might personally do if present." On July 7, 1937, "[w]ithout detracting from the general and specific powers contained in that instrument [of April 16, 1936], I further authorize and empower the said Leston B. Nay to sign in my behalf any proxies, transfers, acknowledgments, accounts, receipts or documents for my securities with the same power and authority as I would myself if present."

In July, 1939, Schueren received a letter headed "Webber, Darch & Company, Leston B. Nay, President" and signed Webber, Darch & Company "by Leston B. Nay." The letter stated, "In accordance with your recent request we

are pleased to enclose inventory of securities held in safe keeping for your account"; an itemized inventory was enclosed.

Nay joined Ryan-Nichols & Co. as vice-president in 1942. Schueren received a letter dated July 31, 1942, on the letterhead of Ryan-Nichols & Co., signed Ryan-Nichols & Co. "by Leston B. Nay, Vice President." It said, "We have received from Webber, Darch & Co. the following securities, which we placed in safe keeping for your account;" following was an itemized list of securities. The name of Ryan-Nichols & Co. was changed to First Securities Company of Chicago on June 24, 1944, at about which time Nay became president and principal shareholder.

From 1946 through 1963, First Securities bought and sold securities for Schueren in *bona fide* transactions which appeared in the books and records of First Securities and which were not tainted by any defalcations of Nay. In connection with these transactions, Schueren received confirmations on the printed forms of First Securities.

For all his securities Schueren received safekeeping receipts. Those appearing in the record were on the printed forms of First Securities and acknowledged receipt by "First Securities Company of Chicago" and showing the typed names and written initials of Campbell, Burke and Walker.

Each month Schueren would receive an itemized list of dividends received on the securities purportedly in safekeeping for him, together with a cashier's check for the month's total dividends. Although a few of the dividend itemizations were on otherwise blank paper, the great majority were typed on the printed letterhead of First Securities with the further printed designation "Member, Midwest Stock Exchange."

Under date of March 17, 1959, Schueren received a complete inventory of his purported holdings, typed on the letterhead of First Securities. Schueren found three discrepancies between his own records of his holdings and those on the March 17 inventory list. He pointed them out to Nay, who wrote Schueren a letter dated March 26, 1959, on the printed letterhead of First Securities, acknowledging the three errors and ascribing them to the typist.

Schueren died in 1967; the Union Bank and Trust Company was appointed his executor. The bank then wrote Nay requesting all of Schueren's securities. On April 27, 1967, Nay sent the bank what purported to be a complete inventory of the Schueren holdings, typed on sheets stamped with the name of First Securities. For more than a year, Nay corresponded with the bank and pretended to be in the process of obtaining transfers of the Schueren securities. When on June 4, 1968, he finally told the bank that the security transfers had been completed and were ready for delivery, he committed suicide. Thereafter the bank learned of Nay's thefts of the securities involved in this claim, which were valued at $394,195.39.

II

Because of the legal conclusions reached in the Hochfelder appeal, it is important to consider the factual basis from which they derived. This court said in *SEC* v. *First Securities Co.*, ..... F.2d ..... (No. 71-1272, April 12, 1972), in the slip opinion at pages 2-5:

> "The fifteen claimants had each been brokerage clients of First Securities, buying and selling securities through First Securities in regular fashion. Each received investment advice from Nay, and each knew Nay to be the president of First Securities. Nay advised each of the claimants that he was able to offer to the claimant an opportunity to invest in a so-called escrow which would yield a high rate of interest. . . . . Typically, upon being persuaded by Nay that the escrow was the best possible investment for them, the claimants sold legitimate securities through First Securities for purposes of obtaining the necessary cash to invest in the escrow. First Securities effected the sales, collected its commissions and submitted the proceeds to the claimants, who then drew their personal checks payable to Nay or to a bank for his account. Subsequent transactions with regard to the escrow were not in the form usual to dealings between customers and First Securities, nor was the escrow reflected in periodic accountings by First Securities to the claimants.

"Upon receipt of the cash investment from the claimants, Nay usually executed a hand-written document which acknowledged such receipt and confirmed the terms of the arrangement. Sometimes Nay gave promissory notes to the claimants. All, or substantially all, of Nay's correspondence with the claimants was written on letterhead stationery of First Securities. Some of the letterhead stationery included the words, 'Leston B. Nay, President,' on the upper left hand portion thereof. All of the stationery bore the legend, 'Member Midwest Stock Exchange,' in addition to the firm's name and address. Although much of Nay's correspondence with regard to the escrow transactions was handwritten by him, a substantial portion was typed by his secretary at First Securities.

"During the early years of Nay's fraudulent enterprise, the claimants were paid interest from time to to time based upon their 'investments' in the escrow. Such payments were made by Nay's personal check. . .

"Finally, it is clear that Nay had no actual authority to act for First Securities with regard to the escrow account. It is also clear that First Securities' employees (other than Nay) knew nothing of the nature of the escrow nor, except for his secretary, even of its existence. Nay had forbidden anyone other than himself to open mail addressed to him, and in his absence all such mail was simply allowed to pile up on his desk, even if it was addressed to First Securities for his attention."

On the basis of the above facts, this court concluded that (1) Nay acted with apparent authority as the common law agent of First Securities; (2) First Securities was a "controlling person" as to Nay within the intention of section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78t(a); (3) First Securities at least aided and abetted Nay in violating section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 promulgated pursuant thereto, 17 C.F.R. §240.10b-5; and (4) First Securities failed to satisfy its duty to supervise Nay pursuant to Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. This court held that First Securities was liable for Nay's fraud to the 15 escrow participants on all four theories.

## III

The parties to this appeal, with a commendable willingness to disclose everything which has occurred in the equitable receivership, included in the record here the evidence relating to, and the disposition by the special master (approved by the district court) of two other pertinent claims.

Norman L. Moyer had appointed Nay executor of his will. When Moyer died on March 3, 1958, Nay as executor took custody of his stocks and bonds. In his final account filed in the probate court, Nay recited that the securities had been distributed to the widow, Nora A. Moyer; actually Nay had delivered to her a safekeeping receipt with a First Securities stamp thereon. The securities never appeared in the records of First Securities and were missing at the time Nay took his life. In recommending allowance of the Moyer claim, the special master concluded:

> "The question . . . is whether the transactions purported to have been carried out, on the broker's side, by Mr. Nay individually or by him on behalf of First Securities. And to this question there is a clear answer: The receipt which was signed in the name of First Securities and which contained a First Securities stamp at the top of each page, and the quarterly statements furnished to Mrs. Moyer as an accounting of dividends and interest received, clearly purported to be documents of First Securities. No question is raised as to Mr. Nay's authority to act as agent and validly sign for First Securities. And Mr. Nay, in his death note, listed the Moyer theft as 'affecting the Company'.
>
> "Furthermore, even if the matter is looked at from the point of view of Mrs. Moyer's intentions, there are indications that Mrs. Moyer relied on First Securities so far as the safekeeping of the securities was concerned. . . ."

A second claim recommended for allowance by the special master and allowed by the district court was that of Arnold C. Schueren's wife, Eleanore A. Schueren, whose relation to Nay and First Securities was similar

to that of her husband except that she had signed no power of attorney.

In allowing the claim of Mrs. Schueren, the district court concluded:

> "Mrs. Schueren's dealings with Nay were similar to those of Nora A. Moyer, whose claim has previously been allowed by the court. Mrs. Schueren received documents purporting to be safekeeping receipts and monthly statements of her account, all on First Securities forms or letterheads. Thus, the preponderance of the evidence establishes that Nay had apparent authority to deal with Mrs. Schueren as the agent of First Securities, and that Mrs. Shueren intended to deal with him in that capacity. I agree with the Special Master's view that the fact that payments were made by cashier's check is not sufficient to negate Nay's apparent authority, or to raise such suspicion as to cause a person using due diligence to discover that Nay did not have actual authority to act for First Securities in those transactions."

IV

Consideration of the facts leading this court to conclude that the claims of the 15 escrow participants against First Securities should be allowed and of the facts leading the special master and the district court to allow the Moyer and Eleanore Schueren claims, causes us to conclude that the Schueren claim should also be allowed despite the existence of the power of attorney.

The power of attorney was executed by Schueren in 1936 and supplemented in 1937. The power and supplement were typewritten forms in which Schueren's name was inserted in handwriting. There is nothing in the voluminous record before us to indicate that Schueren was ever again reminded of the existence of the power of attorney after 1937.

The only evidence in the record which reflects Schueren's intention and understanding is a memorandum dated May 31, 1957, addressed to the Union Bank & Trust Company, in which he refers to the location of the safekeeping receipts:

> "All of our securities, with the exception of a few common stocks are held in Safe keeping by the FIRST SECURITIES COMPANY, 134 South LaSalle Street, Chicago, 3, Ill. Mr. Leston B. Nay is President of this Company."

Like the escrow participants, Schueren was a *bona fide* customer of First Securities quite aside from the tainted Nay transactions. First Securities bought and sold securities for him, he issued his checks payable to First Securities, he received valid confirmations and other documents from First Securities and the books and records of the company reflected these untainted transactions.

What after Nay's death proved to be scores of spurious safekeeping receipts and spurious monthly dividend statements and the spurious inventories in 1959 and 1967 were on the genuine letterheads and forms of First Securities, were apparently in proper order, were often signed by Nay who had "authority to act as agent and validly sign for First Securities," or with the names and initials of persons who were or seemed to be actual officers or employees of First Securities (Campbell, Walker, Burke). Schueren himself kept meticulous books and records. Nothing which occurred during the almost 25 years of Schueren's dealings with First Securities and Nay can be said to have put a reasonable person on notice that anything was amiss. Nay's manipulations of the fraudulent records which were sent to Schueren at least monthly coincided with Schueren's own records of what he believed he owned. Even the trust department of the Union Bank was completely duped by Nay for more than a year after Schueren's death until Nay's suicide.

Nay believed that in his dealings with Schueren he was acting as the agent for First Securities. In his suicide note he said, "The thefts affecting the Company are 1) The Schueren acc't. (Union Bank of Helena . . .) 2) Moyer acc't." He gave detailed instructions to Roy Campbell, the cashier of First Securities, as to where the Schueren files and papers were located.

There is no evidence that anyone at First Securities other than Nay was ever aware of the 1936-37 Schueren power of attorney. There is no evidence that the power

was ever used by Nay. Although it may be speculated that it was used, the facts are that Nay was able to dispose of the Moyer and Eleanore Schueren securities without using or even possessing a power of attorney from them.

As we stated in the prior appeal (slip opinion, page 10):

> "Here, First Securities made Nay its president, provided him with the trappings of a successful investment counsellor, held him out as providing such counsel, and then wilfully allowed Nay's enforcement of a rule regarding the opening of mail which was antithetical to the prevention of frauds of the type which occurred."

First Securities also provided Nay with the printed letterheads, printed safekeeping receipts, rubber stamps and other supplies and accoutrements which enabled him to perpetrate and perpetuate his frauds.

For the four reasons upon which this court allowed the escrow claims in the prior appeal, we conclude that this claim should also have been allowed.

The judgment of the district court is reversed.[1]

A true Copy:

Teste:

.....

*Clerk of the United States Court of Appeals for the Seventh Circuit.*

[1] The only case relied upon by the special master and the district court to reach a contrary conclusion, *Rosen* v. *Hardy*, 238 App. Div. 622, 265 N.Y.S. 154 (1933), was decided by an intermediate state appellate court prior to the enactment of the Securities Exchange Act of 1934, was not concerned with the unique facts present here and apparently has never been cited since its issuance some 40 years ago.

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# In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 665

PAUL H. ASCHKAR & CO., PETITIONER

*v.*

KAMEN & CO., ET AL.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

## BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

### THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. 78a *et seq.*, provides a comprehensive scheme for the regulation of securities brokers and dealers. The Securities and Exchange Commission is the agency charged with the administration and enforcement of this regulatory scheme. It has promulgated the rules and regulations involved in this case and has itself previously taken enforcement actions against respondents (and others of the defendants below) for

their participation in the activities involved in this case.[1]

In a memorandum filed at the invitation of the Court, we urged that the petition for certiorari be granted. We indicated that the decision of the court of appeals that respondents are not liable under the federal securities laws for the fraudulent acts of their employees, acting within the scope of their employment, is inconsistent with the position the Commission

[1] When these fraudulent activities came to light, the Commission sought injunctions against respondents Kamen & Co. and Abraham Kamen, and defendants Laurence H. Ross ("Ross"), Jerome M. Grossinger ("Grossinger") and Frederick Cirlin Associates, Inc., as well as against Jerome, Richard & Co., Inc. ("J-R" hereafter). It obtained permanent injunctions against Ross and Grossinger by default and against Frederick Cirlin Associates, Inc., by consent, and preliminary injunctions against Kamen & Co. and Abraham Kamen by consent and against J-R on a litigated motion. *Securities and Exchange Commission* v. *Kamen & Co.*, 63 Civ. 2331 (S.D.N.Y.); Litigation Release Nos. 2705 (Aug. 5, 1963), 2742 (Sept. 16, 1963), 2948 (May 28, 1964) and 3009 (Aug. 27, 1964). An exemption from registration under the 1933 Act covering the securities of J-R was suspended (Securities Act Release No. 4723, Sept. 16, 1964). Administrative disciplinary proceedings were instituted by the Commission against various defendants in this case. The registration of J-R as a broker-dealer was revoked, and Grossinger was barred from being associated with any broker or dealer. *Jerome, Richard & Co.*, Securities Exchange Act Release No. 7688 (Aug. 27, 1965). Respondent Kamen & Co. was suspended from membership in the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers, Inc., for 10 business days; respondent Abraham Kamen was suspended from being associated with any broker or dealer for 90 days; and the registration of Frederick Cirlin Associates, Inc., as a broker-dealer was revoked. *Kamen & Co.*, Securities Exchange Act Release No. 7695 (Sept. 29, 1966) (Pet. Br. App. 2). Finally, Ross was indicted for and pleaded guilty to violations of the federal securities laws. *United States* v. *Herman*, 67 Cr. 946 (S.D.N.Y.), Litigation Release No. 3974 (April 11, 1968).

has long taken in its administrative disciplinary proceedings, that a broker-dealer firm has necessarily violated those laws in such circumstances (see p. 22, *infra*). In the Commission's view the decision below unduly impedes private rights of action for violations of the federal securities laws, which this Court described as a "necessary supplement" to the Commission's own enforcement powers. *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432. This brief is submitted to set forth the reasons for the Commission's position on the merits of this case.

## STATEMENT

1. Petitioner is a broker-dealer that is not a member of a securities exchange. It brought this action against respondents Kamen & Co. and two of its general partners for damages resulting from certain allegedly fraudulent practices perpetrated by Kamen & Co. through two employees of the firm.[2] The claims for relief were based on the express private right of action for damages in Section 12(2) of the Securities Act of 1933 ("1933 Act"), 15 U.S.C. 77*l*(2), and on implied rights of action for violations of Section 17(a) of the 1933 Act, 15 U.S.C. 77q(a), Sections 10(b) and 15(c)(1)-(3) of the 1934 Act, 15 U.S.C. 78j(b), 78o(c)(1)-(3), and the rules and regulations promulgated by the Commission under the latter two

[2] Default judgments were obtained against the other defendants named: the two employees of Kamen & Co. (Ross and Grossinger), and the securities firm of Frederick Cirlin Associates, Inc. (R. 57).

sections.[3] Relying also on diversity of citizenship and pendent jurisdiction, petitioner alleged the same facts as a basis for relief under the statutory and common law of the State of California. After a full trial the district court, sitting without a jury, ruled that respondents Kamen & Co. and its partners were not liable under the securities acts but were liable under agency principles of California law. The court of appeals reversed the latter ruling, holding that the respondents were not liable under either state or federal law.

2. The fraudulent activities occurred in connection with an effort by Kamen & Co., a member of the New York and the American Stock Exchanges, to obtain business from nonmember securities firms in securities listed on these exchanges.[4] Early in 1963, Kamen & Co. hired two registered representatives, Ross and Grossinger, on the basis of the latters' assurances that they could substantially expand the firm's volume of business by soliciting orders in listed securities from nonmember brokerage firms, if Kamen & Co. would offer certain special services to such firms. Pursuant to this arrangement, Kamen & Co. established a Broker-Dealer Division headed by Ross and Grossinger and gave them authority to solicit business in

[3] The pertinent provisions of the securities acts and the rules and regulations promulgated by the Commission under those acts are reprinted in the appendix to this brief (see pp. 29–36, *infra*).

[4] Securities firms that are not members of these exchanges may have transactions for customers executed on the exchanges only by using the services of a member firm, and they must pay the member firm the same minimum commission as any nonprofessional investor.

listed securities from nonmember firms and to place over-the-counter orders with those firms, presumably to encourage reciprocal business in securities listed on the exchanges.

Ross and Grossinger substantially increased Kamen & Co.'s listed business from nonmember broker-dealers. This business grossed more than $180,000 in commissions for Kamen & Co., of which the firm's share was $36,000. In obtaining this business, however, Ross and Grossinger offered more than the special services actually authorized by respondents. They also offered the nonmember firms "guaranteed" profits by executing over-the-counter transactions in the stock of a shell corporation, J–R. The nonmember firms were not told that J–R stock was intrinsically worthless, that the corporation was controlled by Ross and Grossinger, or that the over-the-counter transactions in the stock were contrived.

Essentially, the fraudulent scheme devised by Ross and Grossinger involved a telephone call to nonmember broker-dealer B to instruct it to buy for its own account a block of J–R stock from nonmember broker-dealer A at a stated price and to sell it immediately to nonmember broker-dealer C at a designated fraction of a point markup. Ross and Grossinger impliedly represented that the transactions were for bona fide orders received by Kamen & Co.; and at least in some instances, including those involving petitioner, they expressly represented that Kamen & Co. guaranteed performance by the other nonmember firms according to the terms specified. There were no

direct communications between A and B or B and C other than subsequent confirmations, payments and deliveries of the securities. After making this arrangement with B, Ross or Grossinger would then call nonmember broker-dealer C and, making similar representations, instruct it to buy from B at the last price and sell to nonmember broker-dealer D at an additional fraction of a point markup. Similar arrangements with other nonmember broker-dealers would and did result in numerous chains of transactions in the worthless J-R securities, at ever-increasing prices within each chain and with each broker-dealer recovering his purchase price plus a small profit as long as the chain continued.[5]

Petitioner was one of the nonmember broker-dealers that were persuaded to commit themselves to the over-the-counter transactions arranged by Ross and Grossinger. On July 10, 1963, pursuant to telephone instructions from Ross and Grossinger, petitioner purchased 700 shares of J-R stock from one broker-dealer at $19.25 per share and agreed to sell them to another broker-dealer at $19.375. On July 17, again pursuant to instructions from Ross and Grossinger,

[5] Neither of the courts below discussed the financial arrangements for keeping these chains in operation. The Commission's opinion in the administrative proceeding against respondents (see p. 2, n. 1, *supra*) indicates that the chains were designed to end in broker-dealers affiliated with Ross and Grossinger (Pet. Br. App. 2, pp. 11, 12). This was apparently feasible since Ross and Grossinger received about 40 percent of the exchange commissions that they generated, and the guaranteed profits given to the nonmember broker-dealer customers through these contrived over-the-counter transactions usually ran about 23 percent of the exchange commissions that the customers paid (Pet. Br. App. 2, pp. 10, 15).

petitioner agreed to purchase 1000 shares at $19.25 and to sell them at $19.50; and on the same day it also purchased another 600 shares, these at $19.00 per share, which were to be sold at $19.25 per share. On or about July 24, 1963, the fraudulent scheme described above became known in the securities industry. Although petitioner did not complete the July 17 agreement to purchase 1000 shares, it had paid $24,875 for the 1300 shares it purchased. When the securities firms that were to have purchased these 1300 shares from petitioner refused to consummate the transactions, petitioner missed out not only on the riskless profit promised by Ross and Grossinger on these shares (less than $500); it suffered an out-of-pocket loss of approximately $25,000.

3. In ruling on the issues of state law the district court made the following findings, as summarized by the court of appeals (R. 67): (1) the fraudulent scheme "was carried out by Ross and Grossinger as an object of their employment, *i.e.*, to secure listed business, and therefore within the scope of their employment;" (2) "Ross and Grossinger had no actual authority to offer or place fraudulent Jerome stock or make any misrepresentations concerning such transactions * * *;" (3) respondents "did not know and had no reason to know of the fraudulent acts of the[ir] agents;" (4) Ross and Grossinger had "ostensible authority to offer and place such transactions and make the representations * * *" and (5) "Aschkar [petitioner] was justified in relying on the ostensible authority of Ross and Grossinger * * *."

The court of appeals set aside the findings of ostensible authority and justifiable reliance as "clearly erroneous," concluding that in the light of petitioner's professional experience and the "unusual nature" of the transactions it should have made inquiry as to "the extent of authority of the agent." Accordingly, it reversed the holding that respondent was liable under state law for the fraud of its employees (R. 68–72).

In ruling on the issues of federal law the district court had concluded that the activities of Ross and Grossinger violated Section 17(a) of the 1933 Act, Sections 10(b) and 15(c)(1)–(3) of the 1934 Act and the pertinent rules under the latter sections and also created liability under Section 12(2) of the 1933 Act (R. 55). The court of appeals did not question this conclusion but assumed that the only premises for holding Kamen & Co. and its partners responsible for those violations were the so-called "controlling-persons" provisions in Section 15 of the 1933 Act, 15 U.S.C. 77o, and in Section 20(a) of the 1934 Act, 15 U.S.C. 78t(a), which provide that "[e]very person who * * * controls any person liable * * *" under the acts "shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable * * *." Since these sections, however, except cases in which "the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist" (1933 Act), or when "the controlling person acted in good faith

and did not directly or indirectly induce the act or acts constituting the violation or cause of action" (1934 Act), the court of appeals held in accordance with the district court's findings of fact that respondents were not liable under the securities laws for the violations by Ross and Grossinger. (R. 67–68).

## SUMMARY OF ARGUMENT

The "controlling-persons" provisions of the securities laws were not designed to deal with customary employer-employee relationships but to remove artificial barriers (by piercing the corporate veil or ignoring "dummy" instrumentalities) against liability of persons who may in fact have caused a violation. Hence, the standards adopted by those provisions are irrelevant to the civil liability of the broker-dealer firm for the frauds of its employees, committed within the scope of their employment.

Because of the national character of the securities market and because Congress has enacted comprehensive federal legislation in this field, the civil responsibility of a broker-dealer for its employees' violations of federal antifraud provisions should be governed by uniform federal standards.

In implementing the remedial purposes of the securities laws, the Securities and Exchange Commission holds a broker-dealer necessarily subject to administrative discipline for the fraudulent activities of its employees while acting within the scope of their employment. Similar considerations also warrant holding the firm liable in damages as a matter of course to a person defrauded in such circumstances. The

federal securities laws were passed to give public investors special protection against their own gullibility. It is inconsistent with this federal policy to impose upon persons dealing with a broker-dealer's agent a duty of investigation into possible limits of his authority. Although greater sophistication may be expected in this connection from other broker-dealers than from ordinary public investors, the practical realities of the interdealer market make the duty of investigation imposed by court below inappropriate even in this context. Accordingly, the court of appeals erred as a matter of law in denying recovery to petitioner because it had failed to investigate the authority of the respondents' agents to engage in the transactions by which petitioner was defrauded.

## ARGUMENT

### I. THE LIABILITY OF A BROKER-DEALER FIRM FOR VIOLATIONS OF THE ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS BY EMPLOYEES OF THE FIRM, ACTING WITHIN THE SCOPE OF THEIR EMPLOYMENT, IS NOT GOVERNED OR RESTRICTED BY THE "CONTROLLING-PERSONS" PROVISIONS OF THOSE LAWS

In accordance with principles long followed by the Securities and Exchange Commission, as we shall elaborate (*infra*, pp. 20–27), petitioner premised his federal claims primarily and explicitly (R. 2, 10, 26, 42, 45) upon the theory that the antifraud provisions of Section 12(2) and 17(a) of the 1933 Act, Sections 10(b) and 15(c)(1)–(3) of the 1934 Act, and the pertinent rules under the latter act, impose a "nondelegable

duty" upon a securities firm to comply with those provisions in its business; and that the violations by Ross and Grossinger, which were committed in the regular course of their employment and in the name of and for the profit of the respondent firm, were necessarily violations by the firm as well. Petitioner thus relied directly upon the express remedy contained in Section 12(2) of the 1933 Act and upon private rights of action that have regularly been implied against persons who have violated the other antifraud provisions.[6]

The court of appeals, however, did not attempt to determine whether the respondent firm and its partners were directly liable under the antifraud provisions for violations of those provisions. Rather, it bypassed the independent force of these sections and instead concentrated on the controlling-persons provisions of Section 15 of the 1933 Act and Section 20(a) of the 1934 Act, treating the standards in these two sections as the exclusive basis for imputing to a broker-dealer the responsibility for statutory violations by its employees. Thus, it construed the controlling-persons provisions as generally precluding a broker-dealer's liability for the frauds of its employees

[6] This Court has held that private rights of action are to be implied for violations of another provision of the securities acts. *J. I. Case Co.* v. *Borak*, *supra*, 377 U.S. at 430–434; cf. *Wyandotte Co.* v. *United States*, 389 U.S. 191, 201–202. The courts of appeals have implied private rights of action under the antifraud provisions involved in this case. *E.g.*, *Ellis* v. *Carter*, 291 F. 2d 270 (C.A. 9), dismissal affirmed, 328 F. 2d 573 (C.A. 9); *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (C.A. 2).

except when certain unspecified principals of the firm are personally at fault.[7]

We submit, on the contrary, that the controlling-persons provisions under which the court analyzed the federal aspect of petitioner's claim are essentially irrelevant in the ordinary employer-employee context, as exists in this case. These provisions were designed to reach situations in which there are technical legal barriers between the persons in fact responsible for violations of the securities acts and those injured by the violations. As we discuss below, the controlling-persons provisions were designed to avoid those barriers by, for example, piercing the corporate veil to reach controlling stockholders. They were intended to enlarge, not restrict, the scope of vicarious liability otherwise arising under the securities acts. Hence, the exceptions set forth in those provisions are applicable only when it is necessary to invoke these expanded premises of liability. Conversely, they are not applicable here because respondents' liability may be and

[7] Both the antifraud sections and the controlling-persons provisions speak of the duties and liabilities of a "person". This term is defined by both acts (Section 2(2) of the 1933 Act, 15 U.S.C. 77b(2), and Section 3(a)(9) of the 1934 Act, 15 U.S.C. 78c(a)(9)) to include a "corporation," a "partnership" and other legal entities. Thus, fraud-doers and controlling persons are not limited to natural persons but include legal entities as well. Since a corporation or a partnership cannot itself have knowledge or reason to know of facts or act in good faith, the exceptions in the controlling-persons provisions can be applied to such legal entities only insofar as the knowledge, reason to know, or good faith of certain individuals is imputed to them. The controlling-persons provisions do not themselves provide any rules for identifying these individuals.

should be determined directly under the antifraud provisions themselves.

The legislative history of the controlling-persons provisions supports this analysis of their precise focus. The original Senate version of the 1933 Act contained a number of provisions designed "to aid in preventing directors from evading the liabilities incident to signing the registration statement * * *."[8] This draft of the Act dealt with the use of a "dummy" signer[9] of a registration statement and made the fraudulent use of a "dummy" unlawful.[10] The House version, which contained registration and antifraud provisions very much like those eventually adopted, contained no sections expressly dealing either with "dummies" or with controlling persons.[11] In conference these "'dummy provisions' which were calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the

[8] S. Rep. No. 47, 73d Cong., 1st Sess. 5.

[9] "Dummy" was defined to mean "a person who holds legal or nominal title to any property but is under moral or legal obligation to recognize another as the owner thereof; or a person who has nominal power or authority to act in any capacity but is under moral or legal obligation to act therein in accordance with the direction of another." S. 875, § 2(k), 73d Cong., 1st Sess. (April 17, 1933), 77 Cong. Rec. 2979.

[10] The bill required the "dummy" signer to disclose his capacity and the identity of his principal or principals; it provided that a "dummy's" signature would be invalid unless accompanied by the signature of his principal, and (in the provision that eventually became Section 17(a)) it made it unlawful to employ a "dummy" to defraud, providing that both the "dummy" and the principal would be violators. *Id.* §§ 4, 13.

[11] H.R. 5480, 73d Cong., 1st Sess. (May 4, 1933).

actual control exercised by one party over the other * * * [were] welded into one and incorporated as a new section in the substitute." [12] The "new section" is what is now the controlling-persons provision of Section 15. Thus, that section was the result of congressional concern with the special problem presented by the use of "dummies", and was not designed to govern the usual employment situation.

The legislative history of Section 20(a) of the 1934 Act indicates that the same Congress that had passed the 1933 Act continued to understand the controlling-persons provisions as applying only in these special circumstances. In describing the provision that eventually became Section 20(a), Thomas C. Corcoran, one of the authors of the 1934 Act, testified: "The purpose is to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section." [13] Although the 1934 Act always contained provisions for the regulation of broker-dealers, Section 20(a) was not thought to have much relevance in that context. Richard Whitney, then President of the New York Stock Exchange, stated that "[t]hese provisions seem to apply more particularly to corporations and officers, directors, and stockholders of corporations than to exchanges or brokers." [14] There is no suggestion in the legislative history of the 1934

[12] H. Conf. Rep. No. 152, 73d Cong., 1st Sess. 27.

[13] *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.)*, 73d Cong., 1st Sess. 6571.

[14] *Id.* at 6639.

Act that Congress contemplated that Section 20(a) could or would be invoked to shield broker-dealers from responsibility for the acts of their employees within the scope of their employment.[15]

The approach adopted in the controlling-persons provisions departs from traditional agency law, and for this reason it is inconceivable that Congress, without giving the slightest expression of such a purpose, intended that the controlling-persons provisions supersede all other principles of agency that would otherwise have applied under the securities laws. To observe the difference in approach we need only turn to the current edition of the Agency Restatement, upon which the court of appeals placed great reliance in analyzing the pertinent California law. The Restatement provides that "[a] principal, although personally innocent, is liable * * ** for the misrepresentations of his agent if actually authorized, apparently or ostensibly authorized, or within his agency powers."[16]

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[15] The exception contained in Section 15 of the 1933 Act and relied upon by the courts below to exculpate respondents was also added to that section at the time of passage of the 1934 Act. The purpose of this amendment was only "to carry out * * * [the] real purpose" of Section 15 without making "[t]he *mere existence of control* * * * a basis for liability if it is shown that the controlling person had no knowledge * * * to believe in the existence of the facts upon which the liability of the controlled person is * * * based." H. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 42 (emphasis added). As discussed more fully at pages 21–24, *infra*, there is more involved than the "mere existence of control" when broker-dealer firms entrust their employees with authority to deal with the public for the profit of the firm in transactions far beyond the employees' own financial resources.

[16] *Restatement* (*Second*), *Agency*, §§ 257 and Comment *b*, 261 and Comment *a* (1957).

Apparent or ostensible authority exists if the third party "reasonably believes from conduct for which the principal is responsible that the agent is authorized to make the representations as made." [17] The controlling-persons provisions of the securities acts, on the other hand, do *not* impose responsibility even when actual or apparent authority is present, if the controlling person is personally innocent. The allowance of this defense in the controlling-persons sections is consistent with the congressional purpose of tempering its *extension* of vicarious liability by allowing such a person to demonstrate his personal freedom from fault. But to follow the unstated premise of the courts below that the standards of these new provisions exclusively control the possibility of imputed liability under other sections of the securities laws would mean, as their decisions reflect, that the federal securities laws would provide *less* protection for persons defrauded by employees of broker-dealer firms than does state law.[18]

This anomalous consequence would unjustifiably offend the policy that the federal securities laws constitute remedial legislation, to be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Bureau*, 375 U.S. 180, 195; *Tcherepnin* v. *Knight*, 389 U.S.

[17] *Id.* § 257, Comment *a*; § 258 and Comment *c*; § 261.

[18] The rules of agency discussed in the text were substantially the same under the original edition of the Restatement, which was published in 1933. *Restatement, Agency* §§ 257 and Comments *a–b*, 258 and Comment *c*, 261 and Comment *a*.

332, 336. Their text should be interpreted "so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." *Securities and Exchange Commission* v. *Joiner Corp.*, 320 U.S. 344, 351 (footnote omitted). The securities acts were passed to expand common law liabilities, not to contract them.[19]

Since, therefore, the standards contained in the controlling-persons sections were not intended to govern where other principles of imputed liability exist, the question then becomes: What are the proper standards of vicarious liability for a broker-dealer under the antifraud provisions of the federal securities laws?

## II. A VIOLATION OF THE ANTIFRAUD PROVISIONS OF THE SECURITIES ACTS BY A BROKER-DEALER'S EMPLOYEES, ACTING WITHIN THE SCOPE OF THEIR EMPLOYMENT, IS NECESSARILY A VIOLATION BY THE FIRM ITSELF

### A. A BROKER-DEALER'S RESPONSIBILITY UNDER THE FEDERAL SECURITIES LAWS IN SUCH CIRCUMSTANCES SHOULD BE DETERMINED AS A MATTER OF UNIFORM FEDERAL LAW IN ACCORDANCE WITH THE UNDERLYING STATUTORY PURPOSES

Congress enacted legislation in this field because it recognized that "traffic in investment securities"[20] is nationwide in character. As stated in the legislative findings in the 1934 Act, securities transactions are "affected with a national public interest * * *", "in

[19] This is illustrated by the fact that Congress deliberately made the express liability provisions in the securities acts more sweeping than the common law; *e.g.*, proof of scienter and reliance are not required under Section 11 of the 1933 Act, 15 U.S.C. 77k, or under Section 12(2) of that Act.

[20] Message from the President of the United States, H. Doc. No. 12, 73d Cong., 1st Sess. 1.

large part originate outside the States in which the exchanges and over-the-counter markets are located * * *", and "constitute an important part of the current of interstate commerce * * *."[21] Many broker-dealers have branch offices throughout the United States, and it is the Commission's experience that in our mobile society the public customers of these firms increasingly tend to utilize these local branch offices as they move about the country for business or pleasure.[22] As in this case, broker-dealers and other professional investors frequently transact their business by long distance telephone.

Given the national character of the securities business and the national plan of regulation, the responsibility of the firm under the federal securities acts should not turn on such fortuitous factors as the place of contracting or the venue of the particular action. Such a rule "would lead to great diversity in results by making identical transactions subject to the vagaries of the laws of the several states. The desirability of a uniform rule is plain." *Clearfield Trust Co.* v. *United States,* 318 U.S. 363, 367. The customer of a

[21] Section 2, 15 U.S.C. 78b.

[22] In 1950, members of the National Association of Securities Dealers, Inc. (about 90 per cent of the broker-dealers in the country), had 1321 branch offices in the United States, less than a third of the total number of brokerage offices. By 1962 the number of branch offices had risen to 4713, which was almost equal to the number of main offices. In 1962 there were nearly twice as many branch offices as main offices in the State of California, the location of petitioner's sole office. Report of Special Study of Securities Markets of the Securities and Exchange Commission, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, at 29–30.

broker-dealer should not be required to consult a local attorney in order to know when the securities firm can be expected to stand behind its employees, and when he must make further inquiry. See, also, *D'Oench Duhme & Co.* v. *Federal Deposit Insurance Corporation,* 315 U.S. 447, 471–472 (concurring opinion).

Thus, the Court has frequently eschewed state law as the basis for filling in the interstices of the federal securities acts. *E.g., Tcherepnin* v. *Knight, supra,* 389 U.S. at 337–338; *Securities and Exchange Commission* v. *Variable Annuity Co.,* 359 U.S. 65, 69; cf. *Brown* v. *Bullock,* 294 F. 2d 415 (C.A. 2).[23] Similar treatment is called for here.

As the Court explained in the *Borak* case, *supra,* 377 U.S. at 434, "it 'is not uncommon for federal courts to fashion federal law where federal rights are concerned.' "[24] When these rights are generally set forth in a federal statute, the starting point for supplying any missing details is the motivating purpose of that statute. Problems "in the penumbra of express statutory mandates" are to "be solved by looking at the policy of the legislation and fashioning a remedy

[23] On occasion the courts have looked to state laws. For example, since the securities acts contain no statute of limitations applicable to implied private rights of action, the courts have used relevant state limitations. Even in this situation, however, the federal fraudulent concealment rule has been engrafted upon the state statutes of limitations. *E.g., Azalea Meats, Inc.* v. *Muscat,* 386 F. 2d 5 (C.A. 5); *Janigan* v. *Taylor,* 344 F. 2d 781 (C.A. 1), *certiorari denied,* 382 U.S. 879.

[24] Quoting from *Textile Workers* v. *Lincoln Mills,* 353 U.S. 448, 457.

that will effectuate that policy." *Textile Workers* v. *Lincoln Mills, supra,* 353 U.S. at 457; cf. *Frost & Co.* v. *Mines Corp.,* 312 U.S. 38, 43–45. Indeed, in matters of remedy the federal statutory purpose is particularly the touchstone for formulating the necessary federal common law. "[I]t is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." *J. I. Case Co.* v. *Borak, supra,* 377 U.S. at 433. Restrictive state laws cannot be allowed to frustrate the provision of adequate relief for violations of federal law. As the Court said in *Sola Electric Co.* v. *Jefferson Co.,* 317 U.S. 173, 176, and reiterated in *Borak, supra,* 377 U.S. at 433:

> When a federal statute condemns an act as unlawful, the extent and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted. To the federal statute and policy, conflicting state law and policy must yield. * * *

Cf. *Pope & Talbot, Inc.* v. *Hawn,* 346 U.S. 406, 408–410.

### B. THE OVERRIDING OBJECTIVES OF THE SECURITIES LAWS WOULD BEST BE ADVANCED BY HOLDING BROKER-DEALERS LIABLE AS A MATTER OF COURSE FOR THE FRAUDS OF THEIR EMPLOYEES PRACTICED WITHIN THE SCOPE OF THEIR EMPLOYMENT

We submit that the interests that Congress sought to protect when it enacted the 1933 and 1934 securities acts can be effectively promoted only by recognizing

that broker-dealers are as a matter of courses responsible in damages to persons whom their employees have defrauded in connection with their employment with the firm. Because of the pervasive prophylactic purposes of the federal legislation, broker-dealers should be held to a rigorous standard of responsibility for the acts of their employees, without resort to such nice refinements of common law agency principles as "apparent" or "ostensible" authority.

The securities acts were passed because it was recognized that investors needed protection in securities transactions. In transmitting to Congress his recommendation for legislation in this field, the President wrote: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.'"[21] Securities are "intricate merchandise,"[22] and Congress recognized that the common law rules developed to deal with transactions involving property of a more traditional nature were inappropriate to the sophisticated transactions involving securities. As the Court said in the *Capital Gains* case, *supra*, 375 U.S. at 195:

> "[I]t would be logical to conclude that Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels."

[21] H. Doc. No. 12, 73d Cong., 1st Sess. 1.
[22] H. Rep. No. 85, 73d Cong., 1st Sess. 8.

Thus, it does not follow that a securities trader should not be held liable merely because a horse trader might escape liability in a similar situation.

In its administrative disciplinary proceedings the Commission has long recognized this crucial distinction and has invariably held that a violation of the securities laws by officers or employees of a broker-dealer firm acting within the scope of their employment is necessarily a violation by the firm itself, and that the degree of fault on the part of the firm is a factor to be considered only in determining the sanction, if any, to be imposed. *E.g., Cady, Robert & Co.*, 40 S.E.C. 907, 911; *H. F. Schroeder & Co.*, 27 S.E.C. 833, 837; *E. H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 379 and n. 45; cf. *National Association of Securities Dealers, Inc.*, 20 S.E.C. 508, 515–516.[27] This is in accord with the well established principle that a corporation or a partnership may be held liable and, indeed, criminally responsible for the acts of its officers or employees within the scope of their employment. The policy underlying this principle is that:

> The business entity cannot be left free to break the law merely because its owners, stockholders * * * [or] partners * * * do not personally participate in the infraction. The treasury of the business may not with impunity obtain the fruits of violations which are committed knowingly by agents of the entity in the scope of their employment. [Footnote omitted.]

[27] The Commission is also authorized to proceed directly against individual officers or supervisory employees of the firm who failed to supervise adequately the actual wrongdoers. Section 15(b)(5)(E) of the 1934 Act, 15 U.S.C. 78o(b)(5)(E).

*United States* v. *A & P Trucking Co.*, 358 U.S. 121, 126 (partnershsip); accord, *New York Central R.R. v. United States*, 212 U.S. 481 (corporation). See, also, *Egan* v. *United States*, 137 F. 2d 369, 379 (C.A. 8), certiorari denied, 320 U.S. 788.

There is no sound reason why this same rule should not obtain in the realm of a civil suit where the person actually injured by the fraud seeks to be made whole by the firm with which he was dealing. Many, probably a majority, of the frauds practiced by securities firms involve misconduct by employees—typically by sales representatives who make false or unfounded representations with respect to securities. It is the Commission's experience that from time to time salesmen actually whet the appetites of gullible public customers by representing that they are breaking their employers' rules by giving them a special deal; for example, by giving them more than the prescribed quota of a new issue of securities. But, whatever the representations made by the salesmen or other employees of the broker-dealer, we have found that investors customarily rely primarily on the integrity, reputation, and responsibility *of the firm itself* rather than on the character of the particular employee with whom they happen to be dealing. It is the firm that is accepting and retaining the profits from the transactions, as Kamen & Co. did in this case; and it is the firm to whom the customer should be permitted and expected to look if his trust has been abused.

When a securities firm confers upon its employees the authority to engage in transactions far beyond

the financial resources of the individual employees, public investors should not be required to ponder whether that firm has also given those employees confidential instructions limiting that authority, or be required to abstain from participation in a securities transaction without first consulting a managing partner to ascertain the metes and bounds of the authority of the firm's representative. Members of the investing public who deal with a securities firm should be entitled to assume that the firm will stand behind the conduct of the employees it retains to deal with the public when they act within the scope of their employment.[28] A broker dealer's responsibility for the acts of its employees could not be expressly waived by the customer.[29] Neither should an indirect waiver be sanctioned in the form of an unwarranted duty of investigation. At the very least, an ordinary public investor who relies on the representations of an employee should never be held to a duty to determine at his peril the extent of the employee's authority, *vel non*, to obtain his participation in a particular transaction.

It is true, of course, as respondents will no doubt argue, that greater sophistication can be expected of broker-dealers and other professionals than of ordinary members of the investing public, and that egre-

[28] We repeat that the courts below concurred in finding that Ross and Grossinger conducted their fraudulent operations within the scope of their employment (R. 50, 56, 67–68).

[29] Section 14 of the 1933 Act, 15 U.S.C. 77n, and Section 29(a) of the 1934 Act, 15 U.S.C. 78cc(a), invalidate waivers of the protection of the securities acts. See, generally, *Wilko v. Swan*, 346 U.S. 427.

giously irregular circumstances should alert the professional not to rely on the employee's affiliation with a respectable firm without investigating his authority in the matter. Nevertheless, the securities acts were not designed to protect only the ordinary public investor; they were intended to protect all persons who purchase and sell securities.[30] It would not be conducive to the remedial objectives of the securities laws to exonerate broker-dealers from responsibility for the business-connected frauds of their employees merely because the person who relied in good faith on the representations happened also to be a professional. Securities transactions in the interdealer market are often much more complicated than those involving ordinary public investors.[31] Furthermore, holding even a professional responsible for investigating the authority of the employee of another firm could be disruptively impractical.

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[30] On this basis it has been held that a private right of action will be implied in favor of a broker-dealer that has been defrauded by its customer. *A. T. Brod & Co.* v. *Perlow*, 375 F. 2d 393 (C.A. 2); cf. *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814.

[31] In this case, for example, the court of appeals determined that petitioner could not rely on "ostensible" authority on the part of Ross and Grossinger because, in the court's view, the transaction being arranged violated New York Stock Exchange Rules. See note 32, *infra*. This is an area, however, where "fine" distinctions have grown up in the interpretation of the Stock Exchange's minimum commission rules in transactions with broker-dealers and other professional investors. *Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 2, at 301–311; Pt. 4, at 223–227. The Commission has recently noted the "complex practices" that have been developed by member firms to give rebates to professional investors. Securities Exchange Act Release No. 8239, at 3–4 (Jan. 26, 1968).

Trust and confidence are the essence of transactions between broker-dealers, who often must commit large sums solely on the basis of a gesture, a handshake or, as in this case, a telephone call. These transactions are often of necessity concluded in a matter of seconds, and there is no opportunity to investigate without risking a price change in a rapidly fluctuating market or losing the transaction altogether. Therefore, even as to broker-dealers and other professional investors, the imposition of a strict duty to investigate the authority of the employee would be inconsistent within the underlying statutory purposes and the realities of the securities market. Petitioner should not be precluded from holding Kamen & Co. and its partners responsible for the fraud of Ross and Grossinger merely because it failed to investigate their authority.[22]

The securities acts were designed to protect all investors, both the gullible and the sophisticated. This

[22] There is no contention that petitioner actually knew that Ross and Grossinger were without authority to engage in these transactions. It is, therefore, unnecessary for the Court to determine whether such actual knowledge would be a valid defense in the case of a public investor, a broker-dealer, or both. Nor is there any issue before the Court whether the customer of a broker-dealer who is a knowing participant in a violation of the securities acts or a stock exchange rule designed to protect the public would be barred, as *in pari delicto*, from recovering against even the firm's employees. The only violation about which the court below charged petitioner with knowledge was a violation of the New York Stock Exchange's minimum commission rule, which is designed primarily to insure the profitability of exchange transactions for its members, not to protect the public from injurious practices. Cf. *Colonial Realty Corp.* v. *Bache & Co.*, 358 F. 2d 178 (C.A. 2), certiorari denied, 385 U.S. 817.

remedial purpose can best be advanced by holding those engaged in the securities business to a rigorous standard of responsibility for fraudulent activities of their employees committed within the scope of their employment.

## CONCLUSION

For the reasons stated above, the judgment of the court of appeals should be reversed and the case remanded to determine petitioner's damages.

Respectfully submitted.

ERWIN N. GRISWOLD,
*Solicitor General.*

PHILIP A. LACOVARA,
*Assistant to the Solicitor General.*

PHILIP A. LOOMIS, JR.,
*General Counsel,*

DAVID FERBER,
*Solicitor,*

ROGER S. FOSTER,
*Special Counsel,*

DONALD M. FEUERSTEIN,
*Special Counsel,*

WARREN K. MORGENS,
*Attorney,*
*Securities and Exchange Commission.*

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